Private Equity Confident about Brazil for 2014

Private equity investors are flocking to Brazil, partly driven by hopes of infrastructure investment opportunities in the run-up to the World Cup games this year and the Olympics in 2016. So while there are plenty of reasons to be bullish, it is also worth noting that all of that interest in Brazil could increase the prices investors must pay for properties, and there are already signs that some investor interest is spilling over to other Latin countries, like Mexico and Colombia, as a result. That is the view of Michael Rogers, EY's global deputy sector leader for private equity, and Stephen M. Sammut, a senior fellow and lecturer at Wharton, who discuss these and related topics in this Knowledge@Wharton podcast. An edited transcript of the podcast follows.

Knowledge@Wharton: Brazil's certainly generating a buzz if you go by the EY/EIU survey, which found that nearly 80% of those surveyed planned to increase acquisitions in Brazil over the next year. That's a pretty staggering number. So why does Brazil looks especially attractive now.

Michael Rogers: I was down a couple weeks ago (in December) and I think there's an overall excitement and buzz relative to the run up to the World Cup and Olympic games. Obviously that's spurring some near-term investment and infrastructure and excitement about getting roads fixed, doing some things around the airports, and just trying to bring Brazil onto the world stage as they'd like to be presented. There's a lot of excitement.

There are some long term trends there – such as the move towards more of a consumer-driven economy; the move of a massive amount of people into the middle class in Brazil; and the desire to be better trade partners on a global basis. They're doing a lot of work with China. And so they're starting to trade more globally and have a much more important footprint on a global stage.

[The country has] a desirable demographic in terms of the age group of their working class. And many consumer-driven industries like consumer products, like financial services, are still nascent in many places and have a tremendous ways to run. I think the private equity folks we've talked to just like the long-term demographic trends there and how that really could lead to tremendous upside potential in terms of growing businesses in that market.

There are still some sovereign issues there, and local issues around security and other things that folks will always focus on and try to continue to improve. But in general a lot of fundamentals for Brazil look very nice. And I think it's what's attracting a lot of new capital down there.

Knowledge@Wharton: Thanks Mike, you laid out a lot of long-term fundamental reasons for Brazil's attractiveness. Steve, would you give us your views on Brazil and also just why you think that 80% of the folks surveyed are so interested in it within the next year. And how big a factor is pricing -- I think there's a bit of a more favorable exchange rate lately, which is a short-term factor?

Stephen M. Sammut: I think the characterization of the macro issues is spot on. And there isn't much I can add to that. So what I'll do is maybe look a little bit more at the micro of what's going on. There certainly have been favorable moves in terms of taxation and fees, to be sure. The other thing that's going on is that the owners and operators of businesses in Brazil have become more comfortable over the last few years in working and transacting with private equity funds. And there's more of a willingness to accept outside money and use that as a source of building a company.

Now there's a major transition issue going on in Brazil as well with respect to the mindset of the operators. Historically the major adjustment that most private equity funds have had to make, especially those who are from the U.S. and have planted flags in Brazil, is that, much like China and India, there's a very profound family business culture in Brazil. And there's usually an unwillingness to part with control. It is not really part of the mindset to take on private equity for the purpose of liquidating my personal position or my family's position in the future. I think the thought process tends to be very long term.

So what has really happened over the last decade is that most of the PE funds have had to move away from the buy-out control position to being providers of growth capital or growth equity. Even that has caused a great deal of tension because those are minority positions. There is very little control or influence over the companies that the private equity firms can exert.

I'm hearing anecdotally that there's something of an accommodation being reached now, where the amounts of money available have become so large that the owner/operators or the promoters of the deals basically acknowledge that they're going to have to surrender to the private equity people some level of control or influence. Now this is all playing out as we speak. And the next couple of years are going to be very interesting to see. What I think is going to happen is, even two or three years ago there was huge concern among the veterans in Brazilian private equity that there was already too much money chasing too few deals, and that has not abated. The fact that there's even more interest in capital rushing in may affect the pricing of opportunities in a very good way from a point of view of the owners, not so good from the point of view of the funds. Whether or not the growth in Brazil is rapid enough to absorb all that is another question.

The only variable in here with respect to the amount of capital may be in the area of infrastructure. As Mike's pointed out, that's really one of the key plays in this, especially in the south. The reason is infrastructure deals absorb huge amounts of capital. In many instances they create the opportunity for deals to be clubbed as opposed to proprietary. So Brazil bears very close scrutiny over the next one to two years. I'm not sure this level of excitement is warranted, but it's real. The survey is totally accurate in what it found.

Rogers: I might just add there I agree with Stephen's assessment. One of the reasons I cited Mexico and Colombia as rising up in terms of their level of interest from folks that we talked to, who have an interest in investing Latin America is the rise of the Pacific alliance. It's almost becoming -- is there too much money? If everybody knows about an investment opportunity, does that already mean that there's too much money headed that way? So I think people are looking at what are some alternative investment paths that we might make besides Brazil that get at some of those same attractive demographics and consumers without having to go in and compete, possibly, as heavily as we might have to in Brazil. I think that's a very relevant point.

Knowledge@Wharton: With all the optimism and favorable conditions out there it was a bit surprising to see that 85% of companies surveyed are not spending enough time on detailed planning and exit preparation. One would think since there's a fair amount of cash floating around and the deal situation looks like it's improving, that they would be hurriedly planning their exit out in detail. Mike, what do you ascribe this to?

Rogers: I think this is a little bit of the outgrowth of the slowdown in the exit path and folks ability to get to market. If you look at a five-year horizon typically entities came in with some original investment thesis. They closed the acquisition. They go through some level of, Stephen used the word performance improvement, or speeding up, accelerating a performance. We tend to use the term value creation within the firm. But they go through some window of value creation and then ultimately an exit process.

If you look at a five-year investment, you're heavily into that value creation phase when you're already beginning to think about exit. And as some of these deals have tailed out into longer-term holds, we're finding that people do tend to think about the exit, but it generally starts to happen in the last six to 12 months of ownership. There are about 85% not spending enough time on detailed planning - essentially one in seven were telling us that they were not planning beyond 18 months for an exit. And we know that in some of these very complex situations you might be planning in some cases two years and beyond.

We've talked to some funds that are best-in-class in this, and they tell us, "really we almost start exit planning on the day we buy." And others the think, "we've really got to get focused on operating this business." It's tougher. The arbitrage on financial engineering has been disintermediated out of this business for the most part. The opportunity to just buy low and sell high has gotten tougher and tougher. Folks know that they have to spend a lot of time on that value-creation phase or performance-acceleration phase. And at the same time they also have to put just as much engineering into the exit process.

So we see people pretty routinely not nagging potential bidders early enough -- maybe failing to identify key risk issues in their own backyard -- and not working as hard as they should on the forecast and the plans. Our sense is that you either have to optimize and realize that value for yourself during your ownership window and be able to demonstrate that appropriately to potential buyers, or you have to, at a minimum, identify all those upsides and make sure that potential buyers are aware of them, so that they will at least pay you for them or pay you partially or you get some value for that.

Because as you might imagine, particularly in the secondary market, if one fund sells onto another fund, the buyer would like to know that there is an opportunity to continue to grow and develop the business -- that not all the synergies have been wriggled out of the business, that there's opportunity to improve and continue to build the business.

So we see some best-in-class folks starting to look at this a couple years out. And we still see people literally caught by surprise as they get into the exit process, not understanding that a piece of their business that they have has some really difficulties with and [will be something] buyers go at directly and want a discount. And so we've been working hard with a lot of our funds to help them understand that, get prepared way out in front, maybe even helping if they're going to use a banker for a sale, helping with who might be good to be on the short list of folks to invite to look at the company. And just make sure they've always got an eye towards exit and they're doing the kinds of things, professionalizing management, professionalizing systems, and making all those improvements they can that blend right into a natural sale process that's neat, clean, concise and ultimately attracts the highest value.

Knowledge@Wharton: Steve, do those survey results match up with your anecdotal experience?

Sammut: For the time period we've been living in it's consistent with what I've seen and heard and observed. But it nevertheless puzzles me that there isn't more deliberate attention and planning placed on this. I think what we've been living through is maybe a resignation that the things that are keeping the window shut are really beyond the control of the fund management. And they have to do with the corporate attitude towards acquisition. And when that is slow there isn't much that you can do to change it.

When the IPO market is not cooperative or when it's completely shut down as it was in China, the reaction is, well, there's nothing we can do about this, so let's just focus on adding value, value creation in the company or performance acceleration. When the timing is right we'll be ready and our property will be more valuable. So yes it is very consistent. But it's not something I would generally advise people to make a habit out of. I think as Mike said the best-in-class funds plan exit once the investment is made, some of them actually work it into their due diligence. So that is a reality of this asset class that you ignore at your own peril.