

Private equity in Brazil

Ready for its moment in the sun

Private equity in Brazil is a special report from Ernst & Young focusing on private equity (PE) activity in this important developing economy.



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Foreward

Approximately eight years ago, economists identified four countries that were poised to emerge as significant powers in the global economy: Brazil, Russia, India and China – the “BRIC” countries. At the time, BRIC countries were collectively contributing about 16% of the world’s gross domestic product growth. Since then, their aggregate importance has exploded. Between 2000 and 2008, BRIC economies represented approximately 30% of global growth; since the onset of the financial crisis, that figure has increased to an astounding 45%.

Brazil in particular is poised for its moment in the sun. After many years of false starts, the country has worked diligently to transform itself into a stable platform for future economic growth. With vast natural resources in a time of increasing global demand, a surging young population with an emerging middle class and maturing capital markets inspiring confidence in investors at home and abroad, the country is ready to transition to a more developed economy.

For these reasons and more, Brazil is the subject of significant interest by private equity (PE) investors worldwide. Activity in the region is up significantly by seasoned investors and new entrants alike. Global PE firms, many of which have long had sporadic dealings in Brazil, are now looking more closely at establishing a permanent presence to capitalize on future opportunities.

In this report, we take a look at some of the factors that are precipitating increased investment in the country, the economic and political backdrop, the opportunity for PE firms, the challenges ahead and the future of PE for Brazil.

The political and economic backdrop

From oligarchs to democracy: a stable platform for growth

Brazil is currently the 10th largest economy in the world, and by many accounts, it could soon be the fourth largest. But it didn't get there easily. It was the successful implementation of the Plano Real (Royal Plan) by then-President Cardoso in the early 1990s that sowed the seeds for the political and economic stabilization that was to come. By the late 1990s, Brazil's high inflation had largely been brought under control and interest rates, while still high by developed-nation standards, had begun trending lower.

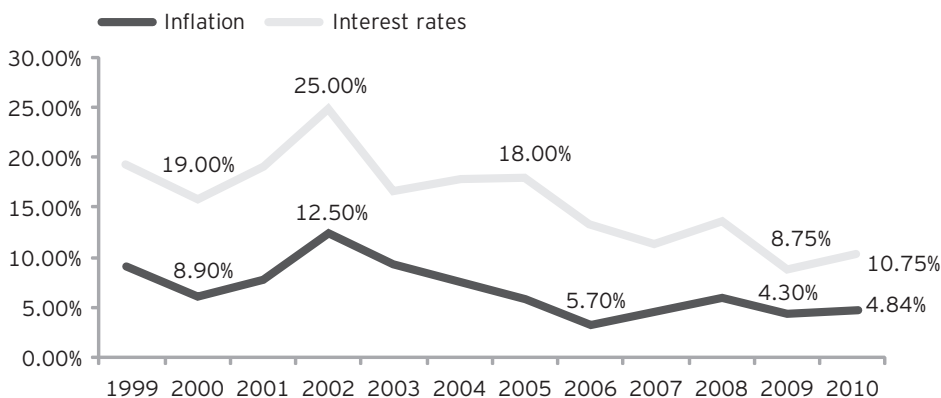
In recent years, Brazil's efforts at reform over the previous decade have begun to pay off. Lending slowly improved, and the country's companies have become increasingly competitive on a global level. Between 2004 and 2008, Brazil's exports more than doubled as companies made deep inroads with new foreign markets, many of which were similarly nascent economies; likewise, the percentage of exports to other emerging markets jumped from 13% to 22% during the time period.

When the global financial crisis peaked in late 2008, Brazil was much better positioned than many of its contemporaries.

The country's central bank had wisely adopted strict monetary policies designed to build and maintain foreign reserves, and the government quickly implemented a stimulus plan designed to keep banks lending and encourage consumption at the consumer level. Interest rates were slashed by 500 basis points. As a result, GDP dipped briefly into negative territory but quickly recovered. In 2009, Brazil's GDP declined just 0.4% from a year earlier, while GDP in the US, the UK and Japan declined 2.4%, 4.9% and 5.2%, respectively.

Important players at the global level took notice of Brazil's success. The country became a net creditor and in April 2008, Brazil's sovereign debt was upgraded to investment grade by S&P (and was soon followed by Fitch and Moody's). Foreign direct investment increased steadily. The country's primary stock exchange, the BM&FBovespa, increased by more than 70% in 2009 (as measured by the Ibovespa index), and between 2007 and 2009, 75 companies priced initial public offerings on Brazilian exchanges, raising nearly US\$50 billion in aggregate proceeds.

Figure 1: Brazil inflation and interest rates



Source: Central Bank of Brazil – SELIC interest rate target; IBGE-IPCA price index as of 3 August 2010

Today, Brazil is a transformed country, having implemented rigorous fiscal discipline and conservative monetary policies, which have left it well positioned for future growth. Brazil's long-term GDP growth rate is projected to average 4.1% through 2040, compared with 2.5% for the US and 1.9% for the EU; and the size of Brazil's economy exceeds its BRIC compatriots India and Russia by a considerable margin. Economic mobility has improved markedly, providing industry with a labor force of increasing quality at a competitive cost and enhancing the country's chances for sustained political stability. Foreign investment in Brazil reached US\$45 billion in 2008, and exports are rising also, driven by the global boom in the commodities and energy markets. The country is at the forefront of many emerging industries – in particular, the increasing interest in biofuels complements the country's position as one of the world's leading producers of sugarcane, leading to increasing exports of cane-derived ethanol.

Brazilians are preparing for two significant events that will soon thrust the country into the global spotlight. In 2014, Brazil will host the World Cup and in 2016, the country will host its first Olympics. The two events are expected to draw hundreds of thousands of tourists, in addition to the already substantial number of visitors that attend Carnival each year. The required investment ahead of these events is expected to top US\$50 billion, and the country is hopeful that it will have a lasting positive effect on Brazil's infrastructure.

Also on the horizon is Brazil's upcoming election. In October 2010, Brazilians will select a new President to replace the immensely popular Luiz Lula de Silva, who is leaving after serving the allowed maximum of eight years. With voters wary of doing anything to disrupt or mitigate the country's recent success, both leading candidates are viewed as centrists who are likely to continue many of the policies of the past two administrations.

Figure 2: Economic facts and figures

	Brazil	World
GDP (at purchasing power parity) (2010)	US\$2.14 trillion	N/A
GDP per capita (2010)	US\$9,886	US\$10,764
Real GDP growth (2010)	5.5%	3.3%
Real domestic demand growth (2010)	6.3%	3.4%
Real private consumption growth rate (2010)	4.5%	2.3%
Real fixed investment growth (2010)	10.7%	4.1%
Unemployment rate (2009)	8.1%	8.7%
Urbanization (2010)	86%	50.5%
Literacy rate (2009)	89%	82%
Population (2009)	201 million	6.8 billion
Median age (2009)	28.9	28.4
Exchange rate (July 2010)	1.77 reals per USD	N/A

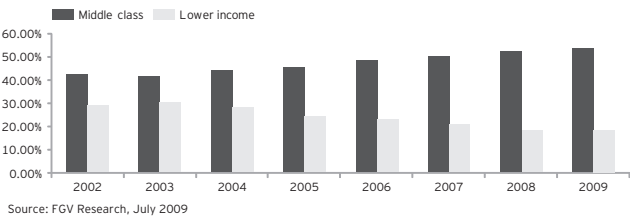
Source: International Monetary Fund, CIA World Fact Book, Global Insight, Capital IQ

Having implemented rigorous fiscal discipline and conservative monetary policies, Brazil is now well-positioned for future growth



Brazil's real story, however, and of greatest interest to PE investors, is the ascendancy of the consumer. Over the last 10 years, partly as a result of government policies designed to stimulate employment, maintain low inflation and better distribute the country's growing wealth, nearly 30 million Brazilians have entered the middle class and they are beginning to consume nearly as much as their counterparts in more economically developed nations. The country is rapidly growing into one of the world's largest consumer markets for everything from shampoo to automobiles. The trend is expected to gather steam as prosperity becomes a self-perpetuating cycle, giving more consumers more dollars for goods and services further up the value chain, driving new opportunities for even more of the country's citizens to share in Brazil's growth story.

Figure 3: Growth of the middle class



Domestic demand is projected to rise 6.3% in 2010 and to continue to outpace global aggregates for the foreseeable future. Lower interest rates and increased accessibility of consumer credit are making home ownership viable for many Brazilians for whom it was previously out of reach. Government policies are encouraging homeownership as well – US\$20 billion has already been provided to low-income families for assistance purchasing over one million homes. Some analysts estimate that more than 35 million families will be looking to purchase their first home by 2030, translating into sustained demand for building materials and consumer durables.

Figure 4: Today, Brazil is one of the world's largest consumer markets

Wall and floor tiles	World's 2nd largest
Cosmetics	World's 2nd largest
Mobile phones	World's 3rd largest
Chocolate	World's 4th largest
Soft drinks	World's 5th largest
Vehicles	World's 5th largest
Computers	World's 5th largest
Education	World's 8th largest

Source: Euromonitor, ANFAVEA, IDC, Abicab, Anfacer; FGV research



The opportunity for PE

Local expansion and greater interest from the global houses

In the last two years, PE firms have taken notice of Brazil's growth and have been increasing their activity in the country. For local PE firms already active in the market, this means a time of unprecedented deal flow and new opportunities. For mega-firms with the interest and the resources but not necessarily significant experience investing in Brazil, it means opening new offices, raising new funds, adding new professionals who are familiar with the local market and putting assets to work in a handful of initial deals.

PE firms have taken notice of Brazil's growth and are increasing their activity.

The evolution of PE in Brazil

The PE industry in Brazil has deep roots sown by a handful of early entrants to the market, including GP Investimentos, Patria Investimentos, Banco Bozano (now Santander), CRP Companhia de Participações, Advent International Brazil and others. Working with Brazil's many family-owned businesses, these firms introduced the business community to the benefits that PE investors can provide: improved corporate governance, a means of succession planning and most importantly, growth capital to fund expansion plans. Early on, deals tended to be smaller and relied little upon debt financing.

These companies' early experiences attracted others eager to replicate their success. Through the mid-1990s, the number of active PE investors in Brazil grew substantially, with some analysts estimating that the number of active investors jumped tenfold, from only 4 in 1994 to more than 45 by 2000. Periodic investments by global houses such as Warburg Pincus, The Carlyle Group, Hicks, Muse, Tate & Furst and others contributed to a sense that investment in Brazil was on a positive trajectory. Between 1994 and 2000, nearly US\$14.5 billion in capital was raised for vehicles targeting Latin America, with much of it directed toward Brazil.

Early investors, however, faced significant challenges. Legal structures and bureaucratic hurdles left over from the pre-Cardoso days hindered transactions; corporate governance was nonexistent at many potential targets; and multiple share classes with different voting rights that gave outsized influence to insiders undermined investors' faith in the capital markets, limiting firms' abilities to exit through an initial public offering. As Brazil entered the new century, activity slowed to a crawl.

A new paradigm

Over the last few years, a new wave of interest has manifested itself in increasing activity on all fronts – from local funds and global powerhouses alike, all intent on increasing the scale and size of investments in the country. Local funds such as GP Investimentos have secured new capital and are investing alongside funds such as Carlyle, which recently closed its first Latin America-focused fund. Advent International, an experienced emerging markets player, recently raised over US\$1.5 billion in its fifth Latin America fund.

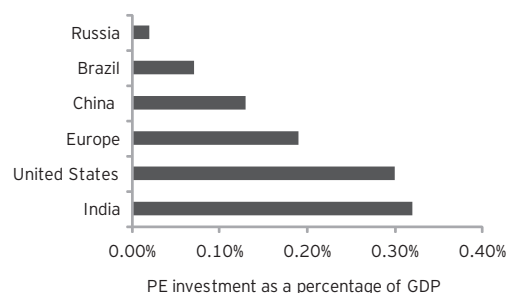
As activity has increased, so too has an understanding of PE's prerogatives and methodologies by Brazil's business community. Entrepreneurs and family business owners that were once wary of working with PE firms are now more accepting. In many instances, business owners have seen firsthand how a competitor or supplier benefitted from PE involvement.

Limited PE penetration

In terms of PE investment as a percentage of GDP, Brazil lags most developed economies, at 0.07%. Among the BRIC countries, only Russia trails Brazil. China has nearly twice the amount of PE activity relative to its GDP, and India is currently the global leader, leading even the US and Europe.

Latin America as a whole is likewise underpenetrated by PE, with the asset class accounting for only 0.03% of GDP. With the economy growing at such a rapid pace, there clearly exists ample room for new entrants to the market and increased activity by existing players.

Figure 5: 2009 PE penetration in select developed and emerging markets



Source: Emerging Markets Private Equity Association, April 2010



Factors driving investment

The dynamics behind increasing PE activity

Brazil's rising status on PE investors' lists and increasing prominence in the global arena are a confluence of many factors: favorable demographics, vast natural resources, a stable political climate and significant infrastructure needs, which are combining to drive interest and activity.

Brazil has the largest population in Latin America

Brazil has nearly 200 million people, making it the most populous country in Latin America and providing an ample workforce to sustain the country's rising exports. Equally important, it represents a growing market for consumer goods and services. Government policies designed to assist the poor through direct subsidies, as well as a nationally mandated minimum wage, have added additional consumers to Brazil's middle class. As a result, private consumption is expected to outpace the country's overall growth rate for the foreseeable future. Brazil's population is young by developed-nation standards and increasingly mobile. Many workers are reversing a long-standing trend of north-to-south migration, as more employers locate in the less-developed northern regions.

Tax incentives for certain investments

Brazil's tax regime is by most accounts overly complex and discourages corporate investment; however, the country is working to change that. One such way is through offering tax incentives designed to promote investment in strategically important industries and regions. As an example, the government recently granted the Ford Motor Company significant state and federal incentives to increase annual capacity. As a result, the company has pledged to invest

US\$1.6 billion to upgrade its plant in Bahia. Regional incentives also exist, in connection with establishing a presence in the less-populated Amazon and Northeastern regions of the country. Certain other key industries are targeted for incentives as well. One example is high-tech. Faced with a rising volume of semiconductor imports, development of a robust domestic technology industry has been on Brazil's radar for several years. Tax incentives are being used to draw semiconductor manufacturers and other high-tech industries to the country.

Industry fragmentation and family succession issues

Certain industries in Brazil are characterized by a high degree of fragmentation - as such, they can present rich opportunities for investors with the expertise and resources to effectively consolidate. Sectors including education, healthcare, and retail are defined by large numbers of smaller firms competing for market share, providing fertile ground for PE roll-ups.

One reason for the lack of industry concentration is the number of family-owned business operating in Brazil. Like much of Latin America, family-owned businesses dominate Brazil's small-and-medium-size business landscape, and family succession issues have historically driven a great deal of Brazil's PE activity. Many businesses are now several generations removed from their founders, and with growing social mobility and increasing opportunities for children of business owners, traditions of passing down the enterprise to successive generations have diminished over time.

Even many family-owned businesses without succession issues are in need of PE; the lending markets in Brazil are significantly underdeveloped and PE represents a viable source of growth capital to take their businesses to the next level - attracting top talent in the form of professional management, making capital improvements, acquiring competitors, and entering new markets.

Maturation of Brazil's capital markets

Brazil's capital markets have undergone a significant maturation over the last decade, inspiring confidence in investors worldwide. Increased transparency in the banking system has enabled better oversight by the country's central bank and regulators. Brazil's bank settlement system now operates in real time, enabling regulators to see issues as they emerge and take appropriate action before problems escalate. Likewise, Brazil's financial markets have undergone a transformation in recent years that has emboldened investors. Changes to rules for publicly traded companies have empowered minority shareholders and improved corporate governance. Among the most important of these is Brazil's convergence with IFRS. Listed companies in Brazil are now beginning to report their consolidated financial statements under IFRS, as are Brazil's financial institutions. The increase in transparency, reliability, and comparability with a growing number of international adoptees is likely to draw even more foreign investors to Brazil in the coming years. Already the BM&FBovespa boasts a market capitalization in excess of US\$1.1 trillion. While still small relative to larger exchanges (the NYSE has a market cap of approximately US\$12 trillion), it demonstrates the impact that regulatory changes can have in attracting investors to Brazil.

Multiple industries with outsized growth potential

While Brazil's economy as a whole has outpaced those of developed nations, not all industries are growing at the same rate. The country has many sectors that provide investors with a risk/reward profile that they would have difficulty duplicating in more advanced economies. For example, energy, agriculture, consumer goods, manufacturing, technology and the budding renewables industry all represent high-growth opportunities in Brazil.

Brazil's vast natural resources are well known, but they remain full with potential. Brazil grows crops on just 20% of its cultivatable land. Additionally, recently discovered oil reserves

are driving investment in the region. In 2007, Brazil's state-controlled oil company announced that it had discovered new oil deposits that could contain more than 33 million barrels of oil, opening the door to increased investment in oil service companies, transport and storage.

At the same time, investment in renewables in emerging economies grew from less than US\$2 billion in 2001 to over US\$65 billion in 2009, with Brazil alone raking in over US\$7 billion. Over 84% of the country's domestic automotive fleet is accommodative of ethanol, and with a growing number of foreign vehicles running on ethanol as well, investment is expected to grow.

Significant need for infrastructure investment

Brazil's infrastructure is in need of substantial investment. Less than 10% of the country's highways are paved and most are in poor condition. Population migration is increasing the need for water and utilities projects in urban centers. The rise in the number of the middle class translates into increased consumption, which can be witnessed in the significantly increased volume of automobile purchases. Many of these are by first-time buyers. As there is limited mass transit, the increase in autos will create more congestion on already busy roadways.

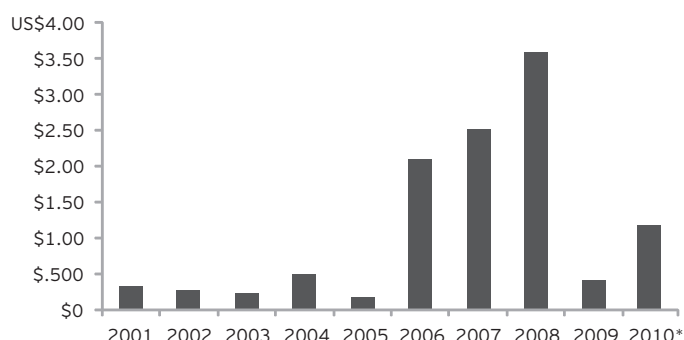
The Lula administration's Growth Acceleration Program, which initially allocated US\$250 billion in government funds toward investment in transport, housing, sanitation and water supply infrastructure between 2007 and 2011, was recently renewed for another three years, with an additional US\$880 billion commitment. At the same time, the World Cup in 2014 and the 2016 Olympics are estimated to require an additional US\$50 billion in investment. While a small percentage is earmarked for stadium development, much more will be spent on inter-urban transport, including airports and roads, urban transport and sanitation. In fact, more than 1,600 separate projects have already been identified for the World Cup.



Emerging markets capturing a larger share of limited partners' wallets

While emerging markets have not been spared the effects of the global slowdown in PE fund-raising, the larger trend clearly favors continued investment in developing economies. A total of 196 PE funds with a stated focus on emerging markets raised a collective US\$22.6 billion in 2009. While that was down significantly from the record-breaking prior year, overall, emerging markets have been capturing a larger share of limited partners' (LP) dollars. In 2001, emerging markets represented approximately 4% of new commitments; by 2009, that percentage more than quadrupled.

Figure 6: Brazil-targeted fund-raising exploded in 2006



* Through 30 June 2010 – annualized

Source: Emerging Markets Private Equity Association, August 2010, in USD billions

Fund-raising for Brazil-targeted funds in particular increased significantly in 2006, jumping to US\$2.1 billion from levels of approximately US\$200 to 400 million in the years prior. As the buyout boom gained steam, so too did commitments earmarked

for the country, topping out at US\$3.6 billion before declining in 2009, consistent with broader industry trends.

The good news: 2010 is off to a healthy start. In April, Advent closed its fifth Latin America fund, securing US\$1.65 billion in aggregate commitments, half of which is earmarked to fund acquisitions in Brazil. The close of Advent V brings the firm's assets under management in Latin America to over US\$5 billion. Eighty percent of Advent's investors are reportedly from Europe and the US and include LP heavyweights such as Calpers, Washington State Investment Board, Alpinvest, GIC Special Investments and others, underscoring the institutionalization of the asset class across the region.

Also in April, GP Investimentos held a final close for GP Capital Partners V, a US\$1.1 billion vehicle targeting opportunities throughout Brazil and the rest of Latin America.

UK private equity investor Actis is also actively pursuing investments in the region. The firm raised US\$2.9 billion for Actis Emerging Markets III in 2007 and set up an office in Sao Paulo last year in order to deploy the approximately US\$360 million that the firm has earmarked for Brazilian investment over the next five years.

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Both long-time investors and new entrants are raising funds

According to Preqin, there are currently more than 15 funds targeting Brazil at various stages of the fund-raising process, seeking an aggregate US\$4.9 billion in total commitments. Many long-time investors in the region, including CRP and Patria Investimentos, are raising funds, as well as global players including Carlyle, which recently held a first close on its US\$500 million buyout fund and is already making investments. The fund recently acquired a 64% stake in CVC Brasil, the largest tour operator in Latin America, as well as a controlling stake in the health care company Qualicorp.

LPs signal increased allocations to Brazil and other emerging markets

As the global fund-raising environment recovers, it is expected that a greater number of assets will be invested in vehicles targeting Latin America. A recent survey by Collier Capital found that emerging markets' share of new LP commitments will increase significantly as investors diversify their PE portfolios globally. Investors with existing exposure to emerging markets plan to grow their exposure from 6% to 10% of new PE allocations to 11% to 15% over the next two years. What's more, Brazil is expected to be a prime benefactor of their interest. Many LPs that have made initial emerging market investments in China and India are now looking to Brazil. Almost 20% of investors with exposure to emerging markets other than Brazil said they would be putting money to work in Brazil over the next two years.

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Driving the interest in emerging markets funds is the search for higher returns that are largely uncorrelated with the rest of LP's portfolios. Many foreign pension funds, endowments, foundations and other LPs are so large that it takes a significant internal rate of return (IRR) to "move the needle," and investors have high hopes for their emerging markets investments in Brazil and elsewhere. Over three-quarters indicated that they expected returns in excess of 16% from their emerging markets portfolios and almost a fifth indicated that they were seeking returns over 25%.

Interest from domestic LPs is also rising. Brazil's pension funds in particular are struggling with the country's steadily declining interest rates. Historically, Brazil pension funds have been restricted to investing in largely passive investments. They are increasingly looking to public stocks and PE to fill the return gap, aided by recent changes in investment restrictions. New regulations will permit investments in the asset class, providing a new avenue for fresh capital.

Figure 7: Funds on the road targeting Brazil

Fund	Type	Target	Raised to date	Status
Carlyle South American Buyout Fund	Buyout	US\$500 million	US\$357 million	First close
Brookfield Brazil AgriLand Fund	Natural Resources	US\$500 million	US\$357 million	Second close
Pátria Brazil Real Estate Fund II	Real Estate	US\$400 million	US\$140 million	Second close
Stratus Capital Partners I	Buyout	US\$300 million	N/A	Raising
CRP VII – Brazilian Middle Market Growth Fund	Expansion	US\$150 million	US\$118 million	First close
Pátria Investimentos Infrastructure Fund	Infrastructure	N/A	N/A	Raising

Source: Preqin, June 2010



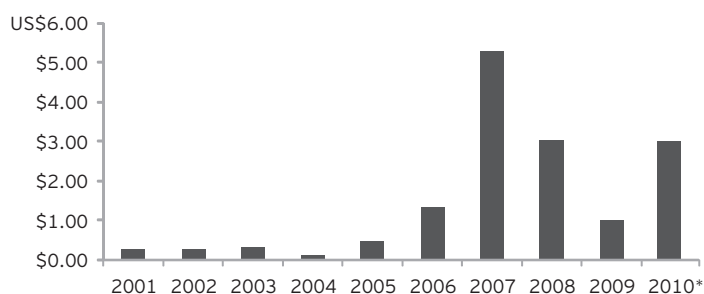
Transactions

PE activity has jumped markedly in the last five years

After stagnating for many years at levels of US\$200 to US\$300 million per year, PE activity in Brazil picked up significantly in 2005, when nearly US\$500 million in new deals were announced. Activity increased dramatically between 2005 and 2007, peaking at US\$5.3 billion. Between 2008 and 2009, activity declined consistent with global merger and acquisition trends. On a year-over-year basis, transactions dropped 43% in 2008 and another 67% in 2009. While such declines are discouraging, activity nonetheless remains much higher than in the pre-boom years.

With significant stores of dry powder available to fund new deals and even more being targeted by funds currently on the road, PE firms are better positioned than ever to execute new acquisitions.

Figure 8: PE investment deals hit a near-term peak in 2007 and are recovering



* Through 30 June 2010 – annualized
Source: EMPEA, August 2010, in USD billions

Just under US\$1 billion in new deals were announced in 2009, including several in excess of US\$100 million. Carlyle's aforementioned acquisition of Brazil's largest tour operator, CVC Brasil, is one of the largest disclosed transactions. Advent executed several deals throughout the year, including its purchases of Cetip SA and education provider Pitagoras.

More recently, Apax Partners announced its first acquisition in Brazil, a reported 54% stake in technology company Tivit SA for US\$921 million. Also, TPG and Gavea Investimentos announced the acquisition of a 25% stake in ethanol Rumo Logistica for a reported US\$225 million.

Figure 9: Significant transactions in 2009 and YTD 2010

Company	Industry	Acquirer	Announced	Deal value
Qualicorp Group	Health Care	Carlyle Group	19 July 2010	US\$1.2 billion
Tivit Terceirizacao de Tecnologia e Servicos SA	Technology	Apax Partners	10 May 2010	US\$921 million
CVC Brasil Operadora e Agencia de Viagens SA	Travel Agencies	Carlyle Group	8 December 2009	US\$250 million
Rumo Logistica SA	Sugar/Ethanol	TPG, Gavea Investimentos	5 July 2010	US\$225 million
Cetip SA Balcao Organizado de Ativos e Derivativos	Finance–Government Sponsored Entities/ Credit Agency	Advent International	8 May 2009	US\$170 million
Pitagoras Administracao e Participacao SA, Controlling Holding Company of Kroton Educacional S/A	Schools/ Universities	Advent International	25 June 2009	US\$142 million

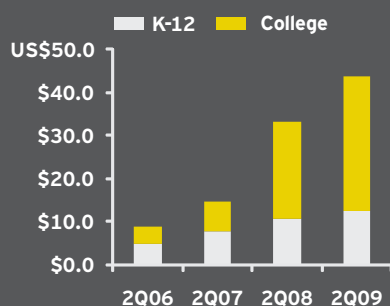
Source: Dealogic; through 5 August 2010

Up close – anatomy of a deal

Advent International's investment in Kroton Educational is worth examining in greater detail, as it represents a consummate Brazil-targeted deal. Kroton Educational is one of the largest private education companies in Brazil. The company was founded in 1966 and is headquartered in Belo Horizonte, in the Southeast region of the country. The company is active in several segments of the market, including primary, secondary and postsecondary education.

Kroton Educational runs approximately 650 K-12 schools located throughout Brazil that educate more than a quarter-million students. The company also runs 28 college campuses offering associate and bachelor degrees across Brazil with an additional enrollment of over 43,000. Approximately 70% of the company's revenues currently come from its postsecondary operations, and while both segments have been growing strong, the college-derived revenues in particular have seen tremendous growth recently.

Figure 10: Gross revenue growth, Kroton Educational



Source: Kroton Educational 2009 earnings release and investor report, in USD millions

The education market in Brazil is highly fragmented and ripe for consolidation. It is also an underserved market; postsecondary education rates in Brazil are low, not only by developed economy standards, but also relative to many of its Latin American neighbors as well. While attendance has risen as a result of government initiatives designed to increase enrollment, the illiteracy rate hovers at around 11%, and a recent study by the Instituto de Pesquisa Economica Aplicada found that the average 25-year old had completed only nine years of education. With the country's newfound prosperity, education is a high priority for many Brazilians – the sector has been growing at a compound annual rate of 10% for the last decade.

In 2007, Kroton Educational went public on the BM&FBovespa, raising approximately US\$224 million. It quickly put proceeds to work implementing an aggressive acquisition strategy and executing numerous deals for smaller competitors, many of which were family-owned businesses.

In June 2009, Advent International invested US\$142 million for a 28% ownership interest, the proceeds of which were used to provide additional capital to fuel Kroton Educational's expansion plans. With the new funding, Kroton Educational acquired IUNI Educacional from the Galindo family in early 2010 – in a deal reportedly valued at US\$208 million. The purchase effectively doubled Kroton Educational's postsecondary student body by adding 16 campuses in the Centre West, North and Northeast regions where Kroton Educational was weak. The combined entities will have a net income of about US\$306 million and give Kroton Educational a leading market position in the education sector.



Private equity exits

Maturing capital markets and regulatory stability are key

The maturation of Brazil's capital markets has been a key factor in the increased focus on the country by PE investors. Until recently, most PE exits were characterized by trade sales to large multinational firms, and this remains a very important exit strategy for PE-backed companies. Indeed, two of the country's largest PE exits last year were sales to multinational firms.

Trade sale options increasing

While trade sales to foreign firms still present the surest exit route for many investors, other options available to PE investors as they ponder their exit plans have been increasing as well. Cash-rich domestic acquirers are increasingly pursuing growth-through-acquisition strategies.

Buscape.com was sold in September 2009 by sponsor Great Hill Partners to South Africa-based media company Naspers for US\$342 million. Buscape was founded during the internet boom in 1999, and the company provides consumers in Latin America with price comparison tools and online shopping services. The company's business model revolves around generating lead-referral revenue from merchants and other parties. According to comScore, the site gets more hits than any other in its segment in Latin America and is the 11th most-visited site in Brazil. Buscape was initially funded with capital from its founders, Unibanco and

Merrill Lynch, and in 2005, control was acquired by US-based Great Hill Partners. The company acquired its sole competitor shortly thereafter and began aggressively expanding its product offerings and geographical reach. The acquisition by Naspers is expected to give the acquirer a well-developed platform for further expansion in Brazil and the rest of Latin America.

Between 2006 and 2009, Brazilian firms spent more than US\$148 billion in more than 900 acquisitions of domestic targets. Strong economic fundamentals, exceptional corporate growth and a trend toward consolidation suggest that continued growth in domestic transaction volumes is likely to continue. Sale to a domestic acquirer provides investors with a buyer that is already familiar with the market, increasing the chances that sellers can successfully realize an investment's full value.

While secondary buyouts have traditionally played a limited role in the Brazil exit market, anecdotal evidence indicates that this may be changing. General Atlantic's recent sale of its stake in Qualicorp to The Carlyle Group in a deal that valued the company at approximately US\$1.2 billion suggests that the global increase in secondary buyouts, which represented about 30% of H1 2010 PE exits, may soon manifest as yet another serious option for PE investors.

Figure 11: Significant exits in 2009 and 1Q10

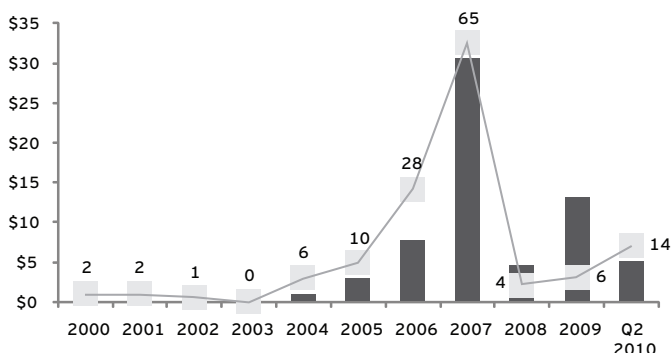
Company	Type	Sponsor	Announced/Priced	Deal Value
Qualicorp Group	M&A	Great Hill Partners	18 July 2010	US\$1.2 billion
Buscape.com	M&A	Great Hill Partners	29 September 2009	US\$342 million
Cinemark Brasil	M&A	Linzor Capital Partners	7 July 2009	Undisclosed
Cetip SA Balcao Organizado de Ativos e Derivativos	IPO	Advent International	26 October 2009	US\$450 million

Source: Dealogic

IPOs offer additional exit route

Perhaps the most exciting development in recent years from a PE perspective is the emergence of Brazil's stock exchange as an exciting venue for initial public offerings. While still small relative to other stock exchanges throughout the world, listings on Brazil's primary stock exchange, the BM&FBovespa, increased from just a handful in the early part of the decade to a peak of 65 companies in 2007 that raised a collective US\$32 billion in gross proceeds. Driven by improvements in corporate governance and a higher level of acceptance among both domestic and international investors, companies have raised more than US\$63 billion in BM&FBovespa listings over the last five years, including the largest PE exit in 2009, the public debut of Advent International's Cetip SA.

Figure 12: IPOs in Brazil from 2000 through Q22010 (annualized in USD billions)



Cross-border listings increasingly viable alternative

Another exciting and relatively new phenomenon is the increasing availability of cross-border listings. While not specific to Brazil, the growing ease with which companies can list on foreign exchanges provides a real opportunity for PE investors in emerging markets. In an era of increasing globalization, fierce competition for listings by the world's equities exchanges means that companies have more choices than ever in regards to where they can list. For emerging markets especially, this helps bridge the gap between companies and institutional capital, provides access to greater liquidity and increases options for investors.

Exits – in depth

Cetip SA Balcao Organizado de Ativos e Derivativos (Cetip) is Latin America's largest central depository for private fixed income securities and derivatives. The company was created through a joint nonprofit venture between Brazil's Central Banks and a number of market participants in 1986 to increase the operational efficiency of Brazil's capital markets. Cetip was demutualized in June 2008, and Advent International acquired a reported 30% stake in the business for approximately US\$161 million in early 2009. At the time of Advent International's investment, the company served as custody agent for assets valued at more than US\$1.1 trillion and managed a daily trading volume of approximately US\$20 billion.

Though already a market leader, there was clearly room for growth. Brazil's OTC derivatives market is still underdeveloped relative to many other countries. As interest rates in Brazil continue to decline and interest among international investors in the region increases, Cetip is well positioned to capitalize on the increase in activity. Just five months after Advent International's investment in Cetip, the company sold 59 million shares on the Bovespa, raising US\$446 million in gross proceeds and allowing Advent International to achieve a lucrative partial exit as a selling shareholder.

In March, one of Brazil's largest commercial real estate firms went public in a listing that raised US\$523 million for the company BR Properties, which is backed by GP Investimentos, Temasek and others. The IPO will provide fresh capital for the firm, allowing it to add to its already sizeable US\$1.4 billion portfolio, while at the same time providing an exit avenue for the company's investors.



Primary challenges and considerations

What are the key considerations for executing transactions in Brazil?

Executing transactions in Brazil is not without certain challenges. Many are common among emerging markets in general, while others are specific to the Brazilian legal, regulatory, cultural and macroeconomic environment. According to the World Bank's 2010 Doing Business report, Brazil is ranked 129 out of 183 countries with regards to the ease of doing business, trailing many other emerging economies including China, Mexico, and Russia. While great strides have been made in recent years, doing deals and operating businesses in Brazil remains a complex and cumbersome process.

According to the World Bank, Brazil has 16 separate processes for opening a business, which take an average of 120 days to complete. These include paying registration fees, applying for operating permits, and registering employees in Brazil's various social programs. Obtaining construction permits can take even longer, averaging more than 400 days from beginning to end, and involving 18 separate processes. The aggregate impact of these and other expenses define what is known as the "Brazil cost."

Despite the current challenges however, Brazil is one of the most active reformers when it comes to improving the operating environment for businesses. Several pieces of legislation are currently under review that are designed to streamline processes and make Brazil more competitive with leading economies. Nonetheless, spending time and resources to conduct a comprehensive assessment of a transaction's risk exposure are critical to ensure success; and for foreign firms less familiar with the country and its norms, working with advisors that are familiar with the workings of the market is crucial.

Unexpected environmental and labor issues

Dealing with Brazil's labor and environmental regulations can be daunting to newcomers. Brazil's labor laws are complicated, tend to be pro-labor and provide relatively generous payments for termination and retirement. Workers in Brazil generally receive generous European-style benefits such as extended vacation allowances and implied job security. When disputes do occur, they are typically resolved in favor of employees. Additionally, labor unions in Brazil are very strong in certain industries and regions and can sometimes wield substantial influence over the success or failure of a given transaction. Likewise, environmental regulations can add confusion and delay. While recent legislation has attempted to streamline the permitting process, Brazil has tough regulations in place to protect the country's vast natural resources. Investors must allot sufficient time and resources to ensure compliance.

Volatile market conditions relative to developed economies

While Brazil has made significant progress toward social, political and economic stability over the last decade, certain legacy volatility still remains. Government expenditures are high - last year, Brazil spent approximately 28.4% of its GDP on government expenditures, which was significantly higher than its neighbors, which averaged 22.5%. Inflation risk remains a concern and the government is inclined to react aggressively amid signs that it is rising. Currency risk is also present - one of the unintended consequences of Brazil's economic success was the effect on Brazil's currency, the real. In 2009, the real gained 35% versus the dollar at the expense of the country's growing export sector. In October 2009, the government imposed a 2% tax on foreign capital inflows and implemented changes to the currency markets intended to counter speculation.

Distinctive PE deal profiles relative to developed economies

Transactions in Brazil are predicated largely upon providing capital funding for compelling growth stories and for industry consolidation. Unlike economies where PE is more established, access to debt financing for acquisitions in Brazil and throughout Latin America is limited. The dynamics of relying primarily on cash as a means of financing lead to smaller deals than in the US, Europe and Asia.

Increasing competition for high-quality deals

The positive factors that comprise Brazil's deal environment have not gone unnoticed by investors. With new entrants to the market executing significant deals and additional capital raises by veteran investors, many longtime market participants are beginning to express concern about increasing competition for high-quality deal flow driving valuations beyond traditional norms. While Brazil's long-term prospects for continued high growth are promising, in the near term, rising seller expectations, a limited number of clear acquisition candidates and increasing flows of PE capital into the nation could drive valuations further.

Regional differences are inadequately factored by investors

Brazil has many regional differences that need to be fully understood and appreciated by investors in order to avoid missteps. While there may exist a tendency to view Brazil as a singular market, Brazil's total area is approximately 8.5 m square kilometers, nearly the size of the continental US. Purchasing

patterns, income, demographics and business customs vary significantly among Brazil's many regions, especially between those located in the north and Amazon Basin and those in the more cosmopolitan south. Investors hopeful of simply replicating an existing business model without taking into account these distinctions are likely to be disappointed with their results – many multinationals learn the hard way that addressing the specific characteristics of each region is critical to success. Partnering with local firms or establishing offices with local personnel can go a long way toward bridging the culture gap.

Technology hurdles

Outdated or nonexistent hardware and application software is common in many smaller and middle market businesses in Brazil, making the collection of information during the due diligence process difficult and creating significant integration issues after a transaction has closed.

When company records are unavailable, benchmarks can often be gleaned from sector sales information provided by the government or market research firms. Barring that, an in-depth and ongoing discussion with target management to produce realistic sales figures, costs and synergies is typically the best way to generate a reliable transaction model.

Lack of transparency

Substantial challenges can exist with regard to the quality and transparency of financial records for target companies in Brazil, so allowing adequate time and resources for thorough due diligence is critical.

In some companies and industries, maintaining a second set of books is not uncommon, leading to unrecorded revenues and expenses, aggressive revenue recognition policies and inappropriately deferred costs. Especially in many family-owned businesses, records are often unaudited, and in many industries, operating a cash business is the norm. These are all issues that can derail a transaction, highlighting the need for experienced professionals to conduct transaction diligence and assist investors in cutting through the opacity and keep deals on track.

Need for managerial talent

One of the key items that PE brings to the table for the middle market companies that represent some of the best opportunities in Brazil is improved corporate governance and professional

managerial talent. With a significant percentage of companies spending generations under family control, many are beginning to onboard a team of experienced managers that can take their companies to the next level. Delivering on that promise, however, can be challenging. In many industries, Brazil lacks a deep pool of management talent experienced in operating large private and public companies. The PE firms that will be successful in the Brazilian market over the coming decade will be those that can successfully recruit and retain top-tier operational talent.

Complexity of Brazil's tax system

Investors in Brazil have traditionally faced stiff headwinds from Brazil's cumbersome tax system. Beginning with the defeat of hyper-inflation in the mid 1990's, Brazil began making substantial changes to its tax statutes that have significantly increased its complexity and accompanying compliance costs. According to the World Bank, with more than nineteen separate taxes, Brazil's tax code places a greater regulatory burden on companies than any other system in the world. Brazil's regulations on worldwide income taxation, transfer pricing, the treatment of capital gains on the disposition of assets by nonresidents, anti-tax haven measures, and more recently, thin capitalization rules, provide challenges for businesses operating in the region. Additionally, investors must often deal with a lack of transparency from administrative authorities which can lead to inadvertent noncompliance, as well as heavy cross-checking between federal, state, and local agencies. Since the general statute of limitations on tax collections in Brazil is typically at least five years, risk exposures can persist for a substantial period several years after a transaction has closed. Penalties are generally higher than other countries, ranging from 75% - 150% at the federal level, in addition to market rate interest.

If Brazil is to remain a growing destination for the world's investment capital, reforms that eliminate redundancies and streamline compliance must be addressed. While progress is being made – the country was recently recognized by the OECD for improvements in transparency – change has been slow. It is essential to ensure compliance that companies doing business in Brazil develop and maintain relationships with sophisticated advisors who understand the nuances of Brazil's tax code.



The case for PE investment in Brazil

Brazil is ripe with new drivers for growth

Building upon a commodities-centered base

Brazil has long been known for its natural resources, and justly so – the country's vast mineral deposits, agricultural capacity and energy reserves have been key drivers of Brazil's economy for decades and will remain an important component as the country marches forward. Newly located offshore oil deposits will yield new jobs and continued investment, and Brazil is already more advanced in the production and use of renewable energy sources than most developed economies, a trend that looks only to accelerate.

The rise of the consumer

In recent years, however, a new, even more compelling story has emerged: political stability, economic strength and the rise of a new middle class. By building up foreign reserves, reducing its dependence on foreign debt, maintaining a watchful eye on inflationary pressures and remaining committed to sound fiscal policies, Brazil has engineered the right conditions for continued long-term growth. The world is responding – Brazil is forecast to attract US\$38 billion in foreign direct investment this year, accounting for more than 3% of global FDI, and behind only China, among emerging markets countries.

The primary beneficiary is Brazil's exploding middle class. Through prescient government policies designed to liberate Brazil's underclass from the cycle of poverty, more and more families are participating in the country's success – more than 27 million Brazilians have moved into the consumer class in recent years, and the number continues to grow. Policies, which have provided direct payments to the country's poor, raised the minimum wage and promoted education by offering incentives to lower class families whose children attend school, all suggest that Brazil's rising middle class is not a short-term trend.

This upward socioeconomic migration is driving desire for a wide array of consumer goods and services, representing a source of strong and growing demand for everything from soda to cell phones and televisions. Where consumer transactions were once handled on a cash basis, lending markets that are becoming more accommodative to middle class needs are creating a consumer credit culture in Brazil that is enabling the average Brazilian to finance purchases such as appliances and automobiles.

Homeownership rates are likewise increasing at a rapid pace. Spurred in part by government assistance to low-income families that allow them to purchase first homes and the increasing availability of long-term home loans, homeownership in Brazil is multiplying. Some observers expect mortgage spending to

increase tenfold over the next five years, as long-term home loans become increasingly available and ingrained in the country's culture.

Coupled with an increase in public spending

In addition to private consumption, public spending is also set to increase over the next several years. Between its two Growth Acceleration Programs, Brazil has set aside more than a trillion dollars for infrastructure projects covering everything from roads to sanitation, housing, hospitals and schools. In all, more than 2,500 projects have been identified, and investments for the World Cup in 2014 and the Summer Olympics in 2016 will necessitate even more investment.

PE activity is intensifying

It is against this backdrop that PE activity is intensifying. Brazil is a direct beneficiary of many limited partners' intentions to increase their exposure to emerging markets over the next several years. Many of the asset class' largest global investors have already begun increasing their allocations and are expected to scale up their exposure even more. Additionally, increasing involvement by Brazil's public pension funds will provide a natural domestic buyer for capable funds.

New fund-raising efforts in Brazil are evidence of Brazil's heightened profile. Several significant funds have closed in the last several months, and many more are at various stages of the process. Longtime domestic players such as GP Investimentos and Patria are joining relative newcomers such as The Carlyle Group. This fresh capital is actively being put to work – investments are increasing, and PE houses are actively engaging the business community in a dialogue about succession, industry consolidation and the growth opportunities available to them by working in partnership with PE.

Increasing exit opportunities

Inspiring confidence in PE investors are Brazil's maturing capital markets. Exit routes, once limited to trade sales to multinational firms, have increased significantly in recent years. While still a very viable exit path, Brazil's domestic mergers market now represents a feasible alternative, as cash-rich domestic firms look to consolidate industries and increase their market share. Likewise, Brazil's capital markets have matured in recent years such that initial public offerings are now in many cases the preferred means of securing an exit, and the growing acceptance and competition for cross-border listings provide yet another means of exiting investments that for all practical purposes, did not exist more than a few short years ago.

Conclusion

In many ways, PE in developing markets, and Brazil in particular, represents the essence of PE – making companies and industries better than they were before. It is an operator's market, where an overall lack of leverage means that innovation, performance improvement and high-quality deal flow supplant the financial engineering play that has been prevalent in the more developed geographies.

With a promising long-term GDP growth rate and conservative monetary policies, Brazil is well positioned as a future powerhouse. Brazil has become a country that is ripe for the type of change that PE can provide: consolidating industries, effecting operational improvement and capitalizing on untapped markets.

The challenges ahead represent rich opportunities for PE firms. For investors with patience, timing, skill and, perhaps most importantly, access to local knowledge and resources, the opportunity exists to actively participate in the coming of age of enormous underserved markets in a vast array of sectors – industrial, technology, energy, infrastructure, consumer goods and more. In Brazil's ascension to the global stage, PE can play a starring role.

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