Ocroma
Alternative Investments

PRIVATE EQUITY UPDATE

Fundraising Report - Brazil

Leonardo L. Ribeiro

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This report presents 2008 year-end statistics on the Brazilian private equity market fundraising activity. It was prepared by Ocroma based on its comprehensive database of Latin American funds currently in the market.

An overview of the market fundraising activity is of great importance because it provides insights about the industry's growth and evolution. It reveals industry trends in terms of fund size, investment focus, remuneration scheme, as well as general fund terms and structures. It also unveils fund returns as managers raising capital usually present their track-record to prospective investors.

METHOD

Ocroma has contacted 104 private equity firms with offices in Brazil and identified 24 private equity funds that were still in fundraising or pre-fundraising phases. Given the extent of Ocroma's relationships in the local market and the depth of its research effort, the firm believes that the identified funds are fairly representative of the population of funds raising capital for investments in Brazil, especially in the segments of growth capital and beyond.

In this analysis were considered only funds that: are managed by firms that have office in Brazil; accept commitments from foreign investors; plan to invest at least a portion of its commitments in Brazil; are established as funds, limited partnerships or limited liability companies in jurisdictions such as Brazil, Cayman and Delaware; and invest only in corporate private equity and not in real estate projects. Given regulatory constraints and confidentiality agreements signed with a few firms, Ocroma is unable to publish the names of funds or firms raising capital. Only those funds that have reportedly made successful closings have their names mentioned in this report.

RESULTS

By 2008 year-end there are approximately 19 firms trying to raise 24 new private equity funds in the Brazilian private equity market. The aggregated target commitments in these funds reach US$ 7.5 billion.

Of the 24 funds, 20 are being raised by independent organizations, targeting a total of US$ 6.7 billion. Only 4, that represent 11% of the aggregate commitments (US$ 831 million) are being raised by organizations that belong to financial institutions. This is consistent with international trends of greater independence of management firms.

Fund size

The biggest fund in the market is targeting US$ 2 billion to undertake large buyout investments and the smallest fund is raising US$ 15 million for seed capital investments. According to Table 1, two thirds of funds, with more than 93% of targeted commitments, have size above US$ 100 million. Funds with target size above US$ 500 million are raising more than 50% of the aggregated commitments, including two funds with size above US$ 1 billion. Clearly, there is a strong increase in fund sizes in the Brazilian market.

Table 1 – Target size of funds currently in the market

Fund Size (US$ million)	Number of Funds	Commitments (US$ million)
< 100	8 (33.33)	486.43 (6.49)
100 to 250	8 (33.33)	1,319.05 (17.59)
250 to 500	5 (20.83)	1,623.81 (21.65)
> 500	3 (12.50)	4,071.43 (54.28)
Total	**24** **(100.00)**	**7,500.71** **(100.00)**

Investment focus

There seems to be a balance between funds targeting buyout deals (11 funds) and those aiming at venture capital investments (13 funds), which includes seed capital, development of green field projects and growth capital. But the bulk (72.25%) of capital being raised will most probably be directed to buyout deals (including PIPE and mezzanine stages), as depicted in Table 2.

Table 2 – Target stages of funds currently in the market

Target Stage	Number of Funds	Commitments (US$ million)
Buyout	11 (45.83)	5,419.05 (72.25)
Venture Capital	13 (54.17)	2,081.66 (27.75)
Total	**24** **(100.00)**	**7,500.71** **(100.00)**

According to Table 3, approximately half of funds have a generalist approach in terms of industry sectors, while the other half is focused in either renewable energy or agribusiness, having bioenergy as a natural and attractive overlap. Although the generalist funds represent more than 2/3 of commitments, some of them also have the two aforementioned sectors as preferred targets for investments. Considering only those funds currently in the market, it is expected that renewable energy and agribusiness will receive at least U$ 2.25 billion and possibly more than 3.5 billion in private equity investments in the next 4 to 5 years (see Table 6).

Other sectors often cited in the marketing material of the generalist funds are: food and beverage, electric equipment, furniture, IT, transportation and logistics, auto parts, pharmaceutical, chemical, retail, consumer goods, healthcare, financial services, nanotechnology, mining, life sciences, tourism, biotechnology, medical equipments, infrastructure, civil construction and education.

Table 3 – Target sectors of funds currently in the market

Target Sector	Number of Funds	Commitments (US$ million)
Agribusiness	5 (20.83)	1,100.00 (14.67)
Generalist	13 (54.17)	5,193.57 (69.24)
Renewable Energy	6 (25.00)	1,207.14 (16.09)
Total	**24 (100.00)**	**7,500.71 (100.00)**

Terms and structures

There is still a tendency for private equity firms that raise capital from international investors to establish their funds offshore, either as limited partnerships (LPs) or limited liability companies (LLCs) in jurisdictions such as the Cayman Islands or Delaware. But these structures are no longer the most popular. As shown in table 4, a growing number of funds are being established in Brazil, often as *Fundo de Investimentos em Participação* under regulation 391 of *Comissão de Valores Mobiliários* – the Brazilian SEC. Still, more than two thirds of capital is raised by offshore funds, as international investors are the source of most of the capital raised by the Brazilian private equity funds, are more familiar with offshore jurisdictions and try to keep away from funds established locally, that have investors sharing control of investment and exit decisions through their investment committees.

Table 4 – Jurisdiction of funds currently in the market

Jurisdiction	Number of Funds	Commitments (US$ million)
Brazil	16 (66.67)	2,407.86 (32.10)
Offshore	8 (33.33)	5,092.86 (67.90)
Total	**24 (100.00)**	**7,500.71 (100.00)**

Private equity funds are usually close-ended investment vehicles with pre-established terms. According to Table 5, the usual terms of the funds currently in the market are either of 8 or 10 years, which means that all exits must be performed before this term comes to an end.

Table 5 – Terms of funds currently in the market

Term (years)	Number of Funds	Commitments (US$ million)
7	4 (16.67)	250.71 (3.34)
8	10 (41.67)	2,080.95 (27.74)
10	6 (25.00)	2,928.57 (39.04)
n.a.*	4 (16.67)	2,240.48 (29.87)
Total	**24 (100.00)**	**7,500.71 (100.00)**

*Includes one fund without term

Private equity funds normally establish an investment period which serves to limit the ability of managers to call capital for new investments and also marks the change in the basis for calculation of management fees. During the investment period the management fee usually applies on committed capital. Subsequently it tends to be applied on invested capital or NAV. While there are funds with investment periods as short as 2 or 3 years, most funds in Brazil have investment periods of 4 or 5 years.

Table 6 – Investment periods of funds currently in the market

Investment Period (years)	Number of Funds	Commitments (US$ million)
2 or 3	6 (25.00)	471.67 (6.42)
4	11 (45.83)	3,592.86 (47.90)
5	4 (16.67)	2,685.71 (35.81)
n.a.	3 (12.50)	740.48 (9.87)
Total	**24 (100.00)**	**7,500.71 (100.00)**

Remuneration

There seems to be a convergence in the remuneration schemes of funds in the Brazilian private equity industry towards the 2/20 scheme that prevails internationally. As depicted in Table 7, 15 funds with 75% of targeted commitments have management fee of exactly 2%.

Only a few smaller funds try to charge more than 2% in order to obtain the minimum revenues needed to run a fund. These are usually in the segment of venture capital and seed capital.

As for those funds charging less than 2%, most are first-time funds trying to differentiate their offers by charging a lower fee and not, as one would expect, the largest funds sharing some of the economics of scale with their investors.

Table 7 – Management fee of funds currently in the market

Management fee	Number of funds	Commitments (US$ million)
2%	15 (62.50)	5,626.19 (75.01)
< 2%	4 (16.67)	1,257.14 (16.76)
> 2%	3 (12.50)	276.90 (3.69)
n.a.	2 (8.33)	340.48 (4.54)
Total	**24** **(100.00)**	**7,500.71** **(100.00)**

While all funds currently in the market charge the same 20% carried interest (carry), the hurdle rate applied to calculate the amount of carry payable to the firm can vary widely from LIBOR to 9.2% above the IGP-M, a Brazilian inflation index composed of the Wholesale Price Index (IPA), Consumer Price Index (IPC) and Construction Cost National Index (INCC) that are weighted at 60%, 30% and 10% respectively.

Another index used by 11 funds is the IPCA, which is calculated in selected metropolitan areas and measures the prices variation of products and services consumed by families with income between 1 and 40 minimum wages.

But the usual hurdle rate is also converging to 8%, which would be applied either to the US dollar in the case of offshore funds or to the IPCA for funds established in Brazil.

Table 8 – Hurdle rates of funds currently in the market

Hurdle rate (%)	Number of funds	Commitments (US$ million)
US$ + 8 or 6	4 (16.67)	3,995.24 (53.27)
US$ + 10 or 12	2 (8.33)	450.00 (6.00)
IGPM + 6 or 9.2	3 (12.5)	310.24 (4.14)
IPCA + 10 or 12	2 (8.33)	190.48 (2.54)
IPCA + 8 or 8.5	9 (37.50)	1,614.28 (21.52)
LIBOR or n.a.	4 (16.67)	940.48 (12.54)
Total	**24** **(100.00)**	**7,500.71** **(100.00)**

Track record

As shown in Table 9, the funds currently in the market are being raised by firms with different levels of private equity experience. Ten funds are being raised by firms with prior track-record. Their follow-on funds plan to raise US$ 3.96 billion, which is a little bit more than 50% of the aggregated target.

New firms with experienced teams (e.g., spin-offs of existing private equity groups) are raising 5 funds that target US$ 2.7 billion. It means that experienced teams in new or existing firms are raising almost 90% of all capital.

Some funds have one or two professionals with prior private equity experience but as part of a newly formed team. These “first-time teams” represent 6 funds targeting almost US$ 500 million.

Finally, only 3 funds with an aggregated target of 340.5 million are being raised by firms with no prior private equity investment experience. However, the management of these firms seems to have certain skills, experiences and relationships that may serve well in the private equity arena.

Table 9 – Experience of firms with funds currently in the market

Level of experience	Number of funds	Commitments (US$ million)
Firm	10 (41.67)	3,964.29 (52.85)
Team	5 (20.83)	2,700.00 (36.00)
Professionals	6 (25.00)	495.95 (6.61)
None	3 (12.50)	340.48 (4.54)
Total	**24** **(100.00)**	**7,500.71** **(100.00)**

In order to raise new funds, the firms with prior experience usually present their track-record to prospective investors. In this report we discuss the internal rates of returns obtained by 17 funds managed by the 8 firms that are raising the 10 funds marked with firm level experience in Table 9.

An analysis of this track-record shows an increasing performance over time, which is coherent with the learning that took place and the improving environment for private equity investments. This becomes visible if the returns are pooled in the three different cycles experienced by the Brazilian industry: i) 1981 to 1997; ii) 1997 to 2004; and iii) 2004 on.

In our analysis, funds with vintages earlier than 1997 posted IRRs of close to 10%, while funds with vintages between 1997 and 2004 posted IRRs that range between 10% and 60%, with most funds around 20% and only one fund in negative territory. Finally, the most recent funds have IRRs above 60% and beyond the three digits. However these are still unrealized IRRs and the final result still depends on the impact of the financial crisis in the valuations of exits.

CONCLUDING REMARKS

For a private equity industry that had only US$ 5.6 billion in commitments in December 2004 and US$ 17.6 billion in June 2007, the US$ 7.5 billion being raised, together with the capital raised in 2H2008, represents an impressive boost to the local private equity industry.

This report presents several industry trends, such as:

- The dominance of independent firms
- Increasingly bigger fund sizes
- Continuous preference for buyouts
- Growth of the venture capital segment
- Focus in renewable energy and agribusiness
- Increasing use of FIPs to structure private equity funds
- Fund terms of 8 or 10 years and investment periods of 4 or 5 years
- Convergence of remuneration towards 2% management fee, 20% carried interest and a hurdle rate of 8% (in US$ or indexed by the Brazilian inflation)
- Increasing experience and returns

Ocroma Alternative Investments

Ocroma Alternative Investments is an investment management and consulting firm based in Brazil, which provides investors with access to alternative investments in Latin America.