

## PRIVATE EQUITY UPDATE

Beating the IPOs

05/2011

This report presents an overview of private equity transactions made in Brazil in 2010 and compares with the previous year. It was prepared by Ocroma Alternative Investments based on its comprehensive database of private equity deals made in Latin America in the course of its fund investment practice.

Main highlights for 2010 were: (i) the significant increase in deals (both in number and size), especially in 2H2010, reaching more than US\$6 billion in 80 transactions and (ii) resurgence of mega deals (above US\$400 million in size) linked to the expressive dry-powder left in international funds that are now redirecting efforts to emerging markets; and (iii) the concentration of investments in a few investment themes related to the growth of the Brazilian middle class and its consumption, moving from companies directly impacted by consumption (e.g. retail) to those that are impacted indirectly (e.g. financial services).

### Funds and managers

2010 was a fantastic year for private equity in Brazil. Forty eight managers closed a deal along the year, including 5 first-time funds which made their first transaction. While both managers with local presence and fly-in investors were active during the year, the numbers are impressive when compared to the industry's size, now surpassing 150 managers.

Tables 1 and 2 bellow shows the top managers that were most active in the number of deals made under and above US\$ 40 MM. This figure was chosen because 50% of transactions are either above or below this ticket size.

**Table 1:** Top 3 managers in volume with deals under US\$ 40 MM

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<b>Managers</b>	<b>Number of acquisitions</b>
Invest Tech	5
Inseed Investimentos	5
DGF Investimentos	3

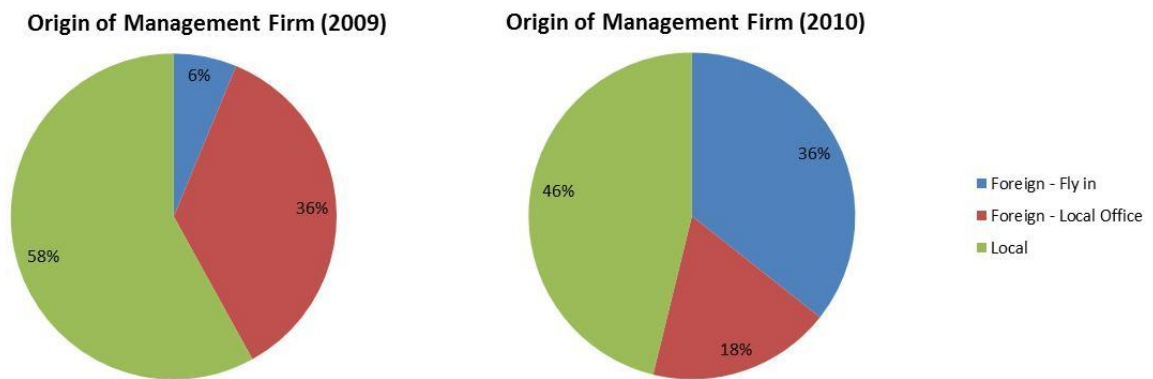
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**Table 2:** Top 3 managers in volume with deals above US\$ 40 MM

Managers	Number of aquisitions
BTG Pactual	5
Actis Capital LLP	3
BR Investimentos	3

2010 also saw a comeback of “Fly-in” investors (foreign managers with no local presence). Having been active in the 90s, they almost disappeared after 2000. In 2009, “Fly-in” investors represented only 6% of deals in Brazil, having jumped to 36% in 2010.

In 2010, Fly-in investors were involved in nine transactions, ranging from US\$25 million to almost US\$900 million in size. But three transactions were above US\$400 million.



**Figure 1:** Origin of Management Firms in terms of Value

With deep pockets, some international fund managers are finding fewer attractive deals in developed countries, forcing them to look after emerging markets, a trend that we believe is going to remain for the following years.

We have seen a similar trend happening in Brazil in the 1990s, when Brazil opened up to international capital and started its privatization program. Many

international PE funds started to explore investing in the country. With very few exceptions, those experiences were not positive and there is the possibility that history repeats itself.

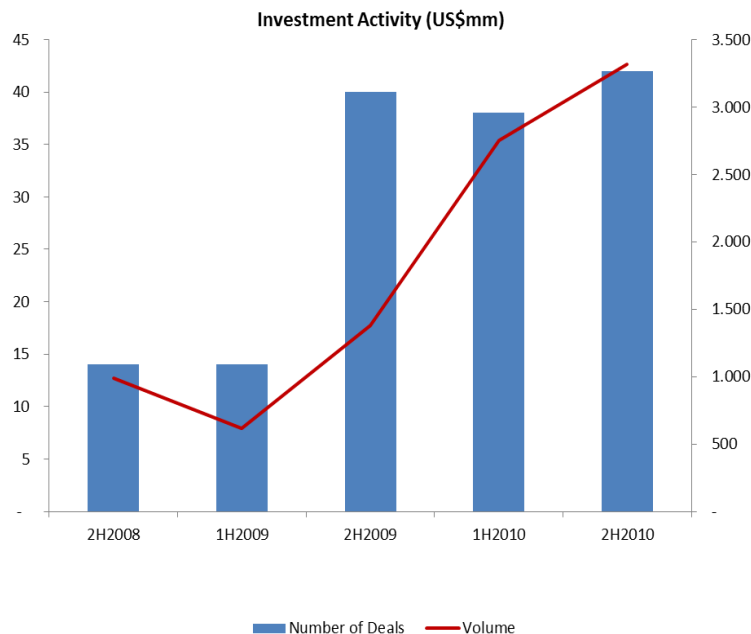
## Deal activity

2010 also set a new all-time record for the industry. Approximately US\$6 billion was invested in 80 transactions.

As mentioned above, contributing to a hot market are international funds that have raised mega buyout funds before the crisis and ended up with less attractive opportunities in developed markets.

According to Cambridge Associates estimates, these funds are now trying to deploy part of their US\$445 billion dry-powder to emerging markets in general and Brazil in particular. As the last LP Survey by EMPEA/Collier Capital shows, Brazil is now the first emerging markets in terms of investor appetite.

We believe this trend will last for the next 2 years and will impact transactions above US\$25 million in size, but mostly those of US\$400 million.



**Figure 2:** Number of deals and volume related by semester

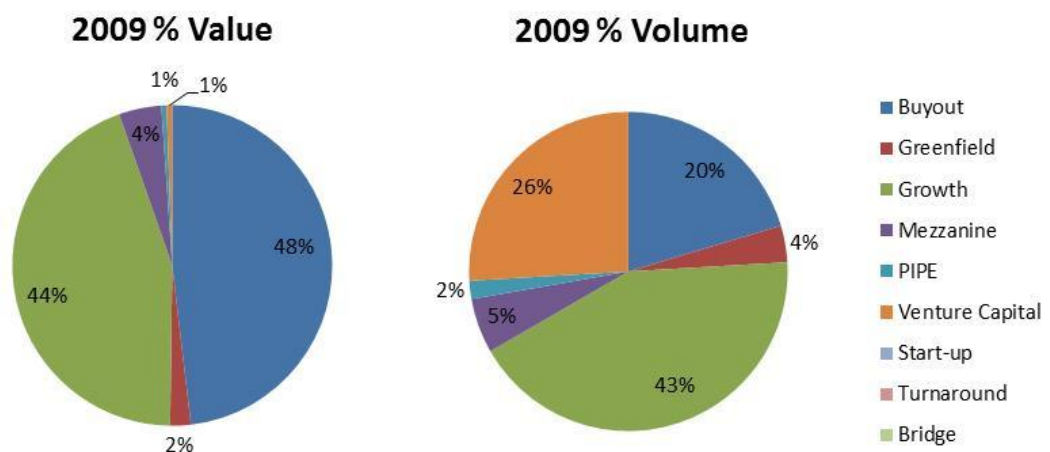
Local pension funds have also had their share in the increased deal activity due to their interest in capital intensive sectors such as oil & gas and infrastructure. According to Center for Private Equity Research at FGV (GVcepe), Brazilian pension funds now contribute 22% of the funds raised by private equity funds that operate and have an office in Brazil.

## Stages

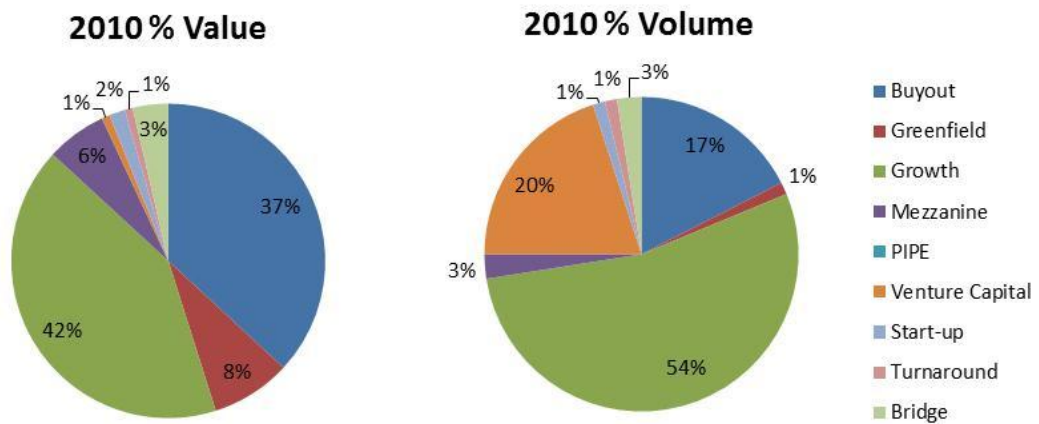
As expected for an economy with high growth rates and a relatively scarce debt market, most of the transactions in the period were aimed at growth and venture capital, while buyouts represented 18% of volume but 37% of value.

Surprisingly, mezzanine investments have grown in size and reached approximately US\$ 380 million, versus just less than US\$90 million in 2009. But it is important to note that three quarters of it refers to a single transaction made in the form of mezzanine to comply with the Brazilian healthcare regulation.

The figures 3 and 4 bellow shows the changes in value and volume of trasactions made in the brazilian Private Equity market over the last two years.



**Figure 3:** Distribution of deals per strategy by value and by volume in 2009



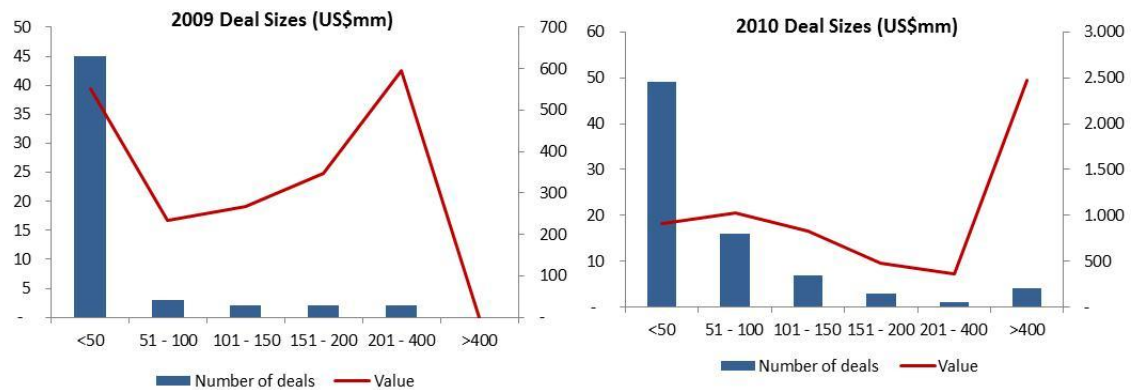
**Figure 4:** Distribution of deals per strategy by value and by volume in 2010

Lastly, PIPE transactions which represented a disproportionate 36% of deal volume in 2H08 have almost disappeared in 2010, implying that potential gains from listed assets are now over, at least from the perspective of private equity fund managers.

### Deal sizes

The average deal size shifted doubled from US\$37 million in 2009 to US\$75,9 million in 2010.

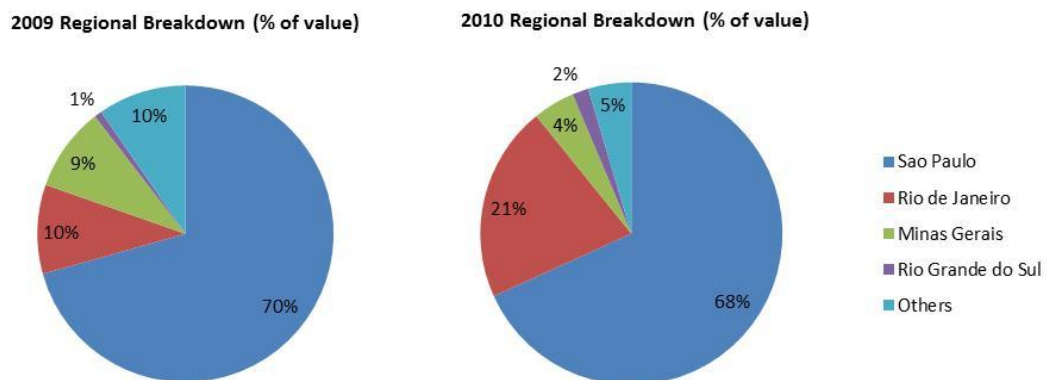
While in 2009 there were no transactions above US\$ 400 million, 2010 saw 4 mega deals adding to US\$ 2.5 billion, or 41% of the aggregate capital invested in 2010. These transactions include: Barra Grande, BTG Pactual, Tivit and Qualicorp. All of those mega deals were made by foreign managers and only 1 (Qualicorp) had a manager with a local team fully operational. This picture is in part explained by the existing pressure and an urgency to do deals in emerging markets out of a billionaire dry powder.



**Figure 5:** Investment activity between 2009 and 2010

## Regional Focus

There has been an increased concentration of deal activity in the States of Rio de Janeiro and Sao Paulo. Whereas in 2009 they both represented 80% of deal volume, this number increased to 89% in 2010. Nevertheless, the nominal amounts flowing to other regions are also increasing.



**Figure 6:** Brazilian regional breakdown by year in terms of value

Again, it seems the increased concentration of deal activity is related to the presence of Fly In investors, as 100% of their deals were either in the States of Rio de Janeiro or Sao Paulo. Certainly, it is more difficult for investors coming from abroad to source and monitor a company in the outskirts of Brazil.

## Industry sectors

Most investments made since the crisis were directed to sectors with a strong link to domestic consumption, the growing and unleveraged Brazilian middle class and infrastructure-related investments, mainly energy and logistics. We believe such trend should be kept constant for the next years, but varying to the degree each company is exposed to those trends (from more direct impact to more indirect or lagged impact).

Below is a table with the main drivers for each specific sector as we have seen from the deals made in the 2009-2010 period:

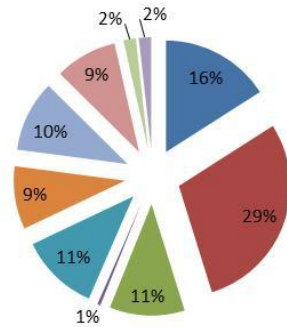
**Table 5:** Factors that influenced the increase of investment by sector

<u>Healthcare</u>	<u>Infrastructure</u>	<u>Retail</u>	<u>Technology/IT</u>	<u>Education</u>
Inefficient public healthcare system	Strong demand for investments	Rise of the middle class	Globalization	Poor public education
Growing demand for services	Poor current infrastructure quality	GDP growth	Innovation incentives	Young work force
Ageing Population	Regulatory changes	Resilient economy	Companies reducing costs and streamlining operations	

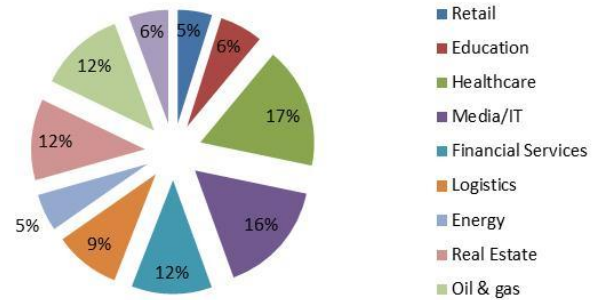
While the trend of consumption-related deals continues, there has been a marked difference between 2009 and 2010. In 2009, more than half of the deals were related to Retail, Education and Healthcare. But in 2010 those sectors lost some traction and were overtaken by deals in Media/IT and Financial Services.

The change in strategy reflects a move to find less obvious opportunities that benefit from the same original trend and also to avoid the overpricing that may be happening in certain market segments.

2009 Sector Breakdown (% of investments)



2010 Sector Breakdown (% of investments)



**Figure 7:** Market sector breakdown

Infrastructure/Logistics maintained a rough 15-20% of deal volume throughout the period. But given the number of Infrastructure-related funds being raised, we believe there will be a surge in those types of investments over the next years.

## CONCLUDING REMARKS

With over US\$6 billion invested in 2010, for the first time in history the Brazilian Private Equity (PE) industry topped IPOs (US\$6 billion raised in 2010) as the primary source of capital for local firms.

Both local funds and foreign funds investing from abroad have contributed to this surge, but the latter are playing an increasing role. Their share of the market increased to 36% from just 9% in the previous year.

It is controversial whether the revival of mega deals by fly-in investors, a trend seen in the 1990s is positive. In the short to medium term it seems to be. As most of the capital flowing in is going to transactions of size above US\$400 million, a new space which can be, but it is rarely tapped by the locally-established firms. Actually, those investors coming from abroad can act as an exit route for many transactions of lesser amount.

But on the long run there is always the concern that those transactions, made by teams without an in-depth market knowledge and network, may end-up as poor

performers, hurting the image of Brazil as an attractive investment destination, just as it happened before.

The data also shows that the Brazilian PE market has increased its depth, as no single manager represented more than 15% the market and approximately 50 of the 150 existing managers made at least one and up to five investments in 2010.

Managers are also repositioning themselves in terms of sectors. While the main thesis fort investment is still linked to the increasing middle class and consumption, clearly managers have been trying to tap other sectors that also benefit from this huge move, but on more indirect or lagged ways. By looking at less obvious niches managers can usually profit from the same economic driver but with companies that may have more attractive entry prices.

Having become a developed private equity markets, the Brazilian PE industry will now start to specialize, with managers slowly diverging from the main theme of consumption-related deals into more opportunistic transactions.

Sector-specific funds, which are still rare, will increasingly have a role in the local market. There should be a growing number of managers, many spinning off from their original firms. Lastly, Venture Capital, which is still relatively small in Brazil, should start to play a more important role in the local investment industry.

2011 may easily exceed the private equity activity of 2010 as foreign firms should continue making relevant investments in the region and fundraising activity peaks (there are more than 40 funds currently in the market). We also expect more transactions in the sectors that support the growth of the consumption in Brazil, such as financial services, logistics and infrastructure. On a different path, we foresee some transactions in sectors related to capital goods and commodities (such as oil & gas and agriculture products).

## **Ocroma Alternative Investments**

Ocroma Alternative Investments is the first private equity fund-of-funds manager focused in Brazil and Latin America. The firm is formed by professionals with deep private equity investment and research experience, unique local market knowledge, established relationships with private equity groups and expertise in a broad array of alternative assets.

Ocroma invests with best-of-breed country-specific funds and regional funds, with a core position in Brazil. The firm invests US\$5 million to US\$15 million per transaction and seeks to diversify its investments in a broad array of stages, including growth capital and buyout. It can also undertake co-investment opportunities with select funds.