

FUNDAÇÃO GETULIO VARGAS
ESCOLA DE ADMINISTRAÇÃO DE EMPRESAS DE SÃO PAULO

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**INTERNATIONAL PRIVATE EQUITY FUNDS STRATEGIES IN THE
BRAZILIAN MARKET**

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Campo do conhecimento: Estratégia

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ABSTRACT

The Private Equity Market in Brazil has flourished in the last two decades, and international Funds have been entering the market since then. The activity of these enterprises and how they deal with institutional voids that are present in the Brazilian market and the all spheres of distances they have with Brazil are investigated in this research. What are the main challenges for those players in the local market and how private equity functions in Brazil?

The first chapter reviews all the literature that concerns private equity in their home countries, such as the United States and Spain (Europe) and Brazil. It also discourses about the concept of private equity in all its different senses, the routine of investees and how is the relationship between Private Equity Fund and Investee. In addition to that, the due diligence process is also explained as well as the private equity sector in Brazil and its regulation. Moreover, the distance between countries and how it affects business is presented followed by the concepts of institutional voids.

For the inquiry proposed interviews were conducted in order to capture the perspective of International Private Equity Funds on the Brazilian market. Advent International, The Carlyle Group and Mercapital replied to the inquiries and provided the tools so a picture of the sector was developed. This sector has a range of challenges and opportunities and requires the International Fund to establish a local branch in order to really succeed in the market.

The results of this project pointed out to the challenges the market presents and how International Private Funds are coming about it. There are definitely gaps that need to be fulfilled however the industry is going in the right direction. Revenues may change its nature in the next couple of years, however from the Private Equity Fund perspective Brazil has been a worthwhile investment.

Nonetheless, it is important to question the vision also of the investee and institutional investor so one can have the entire picture of the sector.

Key Words: Private Equity, Foreign Funds, Institutional gaps, investees, strategic relationship.

RESUMO

O Mercado de Private Equity no Brasil tem se desenvolvido bastante nas últimas duas décadas e fundos internacionais têm penetrado a indústria desde então. A atuação destas empresas e como elas lidam com as deficiências institucionais brasileiras e todos as dimensões de distanciamento que encontramos entre os seus mercados de origem e o Mercado brasileiro são pesquisados neste trabalho. Qual são os principais desafios para estes atores no Mercado local de Private Equity e como a atuação dos mesmos se dá em solo brasileiro?

O primeiro capítulo se direciona á revisão literária de publicações acerca de Private Equity nos países de origem dos fundos estrangeiros como Estados Unidos e Espanha, além do mercado Brasileiro de Private Equity. Além disso também se discorre á respeito do conceitos de Private Equity e suas diferentes perspectivas, a rotina das empresas investidas e como é regido o relacionamento estratégico entre o fundo de Private Equity e a empresa investida. Adicionalmente, o processo de diligencia também é abordado assim como a regulamentação da indústria no Brasil. Ademais, a distancia entre os países e como isso afeta o relacionamento de negócios e as deficiências institucionais também são apresentados.

Adicionalmente, para o objetivo desta pesquisa foram conduzidas entrevistas de maneira á observar a perspectiva do mercado, em especial, dos fundos internacionais instalados no Brasil sobre o tema proposto. Advent International, The Carlyle Group e Mercapital foram entrevistados e suas respostas deram suporte para a criação de uma panorama do setor. A indústria de Private Equity possui uma gama de desafios e oportunidades e requer que os atores internacionais estabeleçam filiais no mercado local para que tenham sucesso.

Os resultados deste projeto apontaram os principais desafios do mercado e de maneira os fundos internacionais estão lidando com os mesmos. Existem

deficiências que necessitam de soluções entretanto a indústria está caminhando na direção correta. O perfil das receitas tende a mudar nos próximos anos, entretanto, de uma perspectiva dos fundos internacionais o Brasil tem sido um investimento que vale a pena. Todavia, é importante pesquisar a visão das empresas investidas e dos investidores institucionais para que se possa ter uma imagem completa do setor.

Palavras chave: Private Equity, Fundos Internacionais, deficiências institucionais, empresas investidas, relacionamento estratégico.

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1. Introduction to Research Problem

The Private Equity financial model was first employed in the United States and was developed according to the Institutional context of that country, which can be translated into mature financial and banking systems, strong institutions and lack of strong governmental constraints (Ribeiro & Carvalho, 2008). Moreover, developed economies also share similar environmental contexts in terms of maturity of their financial and banking systems, contrarily to Brazil. In spite of that, the industry of Private Equity in Brazil has been growing in a steadily pace. As of 2009, there was U\$ 36 billion committed capital.

Currently, there are 144 PE&VC firms in Brazil. (2010 PE/VC Survey) The figures are intended to illustrate the dimensions of the market in Brazil and how it is enhancing its borders. As the world economy has been changing great attention has been given to developing economies, as the case of Brazil, how mature markets players/investors are dealing with the Brazilian market in terms of management of firms they have invested in and which strategies they are deploying is an important inquiry.

The concern regarding differences across countries is not a novelty in the academic debate; however it remains substantial when analyzing business industries within different countries, since the environmental context plays a significant part in the success and failure of business ventures. In order to assess this differences and challenges between markets the framework of analysis to be used in this dissertation will be the CAGE one, as stated by Ghemawat (2001). The author (2001) suggests that one have four dimensions of distance cultural, administrative and political, geographic, as well as, economic distance, and that those distances vary according to the industry one is studying. Financial institutions are actually an international benchmark; in spite of that they are directly tied to national environments. Bottom line is,

how foreign investors deal with their infusion of capital in the Private Equity market/investees, what are their strategic concerns and how this relationship progresses, being a long-term investment.

Objective – Research questions

The objective of this dissertation is to identify, through a case study, what sort of adaptation had to be developed by a foreign investors/market when dealing with Brazilian Private Equity environment or, directly with invested firms.

1. What have this fund learned about the management of investees in Brazil?
2. How has this learning process developed?
3. Are there still major gaps to be fulfilled in terms of managerial strategy or practices?

Justification

This inquiry is important to highlight some of the Brazilian specificities in terms of institutional environments, strategy and managerial practices and how a foreign investor has addressed them. The global and more specifically Brazilian market of private equity has been growing steady in the last couple years; nonetheless, there is still a lot of confusion about this segment of alternative assets. The study of the private equity industry is extremely relevant, once the market has been expanding in Brazil and there is a lack of complete understanding about the segment, its definition and how the industry has been adapting its processes to the emerging market, specifically Brazil.

As far as the framework of analysis selected is concerned it is expected that it will highlight the main cultural and strategic challenges and adjustments that were faced by the actors in the market. Hence, this study will help readers to understand the market, its nature and how it has been functioning in Brazil in the last couple of years; challenges ahead will also be detected completing the picture of the market and its evolvement.

Structure of the thesis

Following the framework proposed by Bloomberg and Volpe (2008) the thesis structure will be organized in the following manner:

- Chapter 1: Introduction to research problem
- Chapter 2: Research methodology
- Chapter 3: Literature Review
- Chapter 4: Presentation of findings
- Chapter 5: Analysis and interpretation of findings
- Chapter 6: Conclusion and recommendation

2. Methodology

The dissertation is going to be a qualitative study, more specifically, a case study or sector study since the aim is to analyze the private equity sector in Brazil, giving emphasis to the foreign private equity funds that have established subsidiaries in the country. In order to access the perspective of the market for the study primary data was selected and interviews were conducted with the targeted audience, moreover, literature review is also used in order to give context to the topic being discussed. Therefore, for the purpose of this research three Foreign Private Equity Funds established in Brazil have been interviewed, they are: Advent International, The Carlyle Group and Mercapital.

The selection process for the funds interviews was on a try-out basis whereas a list of foreign funds with subsidiaries in the local market was drafted, as a second step the 12 funds were contacted and the three selected funds were the ones willing to provide all the information needed for this analysis. It is important to highlight that having differences between the interviewees enriched the analysis, despite the fact that the similarity of coming from abroad was the first spectrum of selection for these funds. Moreover, having three different cases was necessary in order to have an idea of how the local sector works, since only one case could be too specific and not provide all the information necessary.

In order to organize the interviews, a scrip was developed. The conversations were not tied to a strict schedule, but were directed in order to touch upon the main characteristics of the market that were highlighted in the literature review. Further below, one can find the main topics that were brought up during the interviews:

Strategies in Private Equity
Implement aggressive performance based compensation for management to improve performance once they align management interests with the company's objectives.
Enhanced risks when placed as a minority shareholder in Brazilian companies.
Carefully drafting of shareholder agreement.
One of the main characteristics of a Brazilian private equity is that it participates in the decision making of the investee, notably through the appointment of a board of directors.
How effective are the country's banks, insurance companies, and mutual funds in collecting savings and channeling them into investments?
Are financial institutions managed well? Is their decision making transparent?
Can companies raise large amounts of equity capital in the stock market? Is there a market for corporate debt?
How the venture capital industry allows individuals with good ideas to raise funds?
How reliable are information on company performance? Do the accounting standards and disclosure relations permit investors and creditors to monitor company management?
Do independent financial analysts, rating agencies, and the media offer unbiased information on companies?
How effective are corporate governance norms and standards in protecting shareholders interests?
Are corporate boards independent and empowered, and do they have independent directors?
Are regulators effective in monitoring the banking industry and stock markets?
How well courts deal with fraud?
Do laws permit hostile takeovers? Proxy fights?
Is there an orderly bankrupt process that balances the interests of owners, creditors and other shareholders?
Deep structural change in the ownership patterns of Brazilian companies (widely - held)
Premium for control - minority shareholder
Overvaluation - big ticket deals
Novo Mercado
FIP
Exit IPO
A potential short of professional could slow the industry's growth.
The strategy most used by Foreign PE Investors in Brazil is to acquire alone or with a local partner, a controlling position in a company through the purchase of common stock or other voting interests in the company.
Banking lending spreads remains extremely high due to: the credit risks associated with judicial enforcements of contracts, high mandatory reserves requirements, Absence of competition in the debt markets, macroeconomic factors have worked against the development of a vibrant local debt financing market that could nurture a more attractive PE market with the financing characteristics that exists in more developed financial markets.
PE players in Brazil operate very low leverage due to the country's high interest rates. It is a different model and present less risk. In this scenario PE players need to make strategic or operational improvements rather than relying on financial engineering.
Banking lending spreads remains extremely high due to: the credit risks associated with judicial enforcements of contracts, high mandatory reserves requirements, Absence of competition in the debt markets, macroeconomic factors have worked against the development of a vibrant local debt financing market that could nurture a more attractive PE market with the financing characteristics that exists in more developed financial markets.
Arbitrage.

Tax Burden.
Welcoming laws to foreign investment.
Risks and costs that will arise from barriers that are result from distance.
Cultural distance.
Geographical distance.
Administrative Distance.
Economic Distance.
Information technology and global communications are shrinking the world.
Trade unions.
National measures such as protectionism can create administrative and political distance.
Tariffs, trade quotes, restrictions on foreign investment, subsidies, favoritism in regulation.
A target country weak institutional infrastructure can serve to dampen cross-border economic activity.
Corruption and social conflict will depress trade and investment far more than any explicitly administrative and policy restriction.
Functioning of the Brazilian legal system.
A recent study suggests that cross border equity flows between two countries fall off significantly as the geographic distance between them rises
Level of information infrastructure.
Companies that face geographic distance problems will generally go to direct investments.
Effects of economic disparities the cost and quality of financial, human and other resources.
Cross-country complexities place a premium in responsiveness and agility.

3.Literature Review

3.1 Concept of Private Equity

In order to look at the industry of private equity one must first comprehend that there are different visions about what private equity consists of. Gilligan & Wright (2010) would say, "Private Equity is risk capital provided in a variety of situations, ranging from finance provide to business start-ups to the purchase of large, mature companies and everything in between." Using a more formal and academic definition Ellis (2011) states that Private Equity in broad terms is " medium to long term finance provided in return for an equity stake in companies which is later sold to generate return for the investors".

" Private Equity is the term generally used to describe the sector of the finance and investment industry that invests in or acquires a company's securities in a negotiated process, with the intent to actively implement a value-added management strategy to transform the company's capital structure, operation and management" (Angus & Pargendler, 2010)

Private equity, the business of buying, building and selling companies for a profit and returning value to investors, is still a relatively young asset class that it not widely understood. And because it is often lumped together with hedge funds, real estate and other 'alternative' investments, the unique characteristics of private equity are often ignored or overlooked. Ellis (2011)

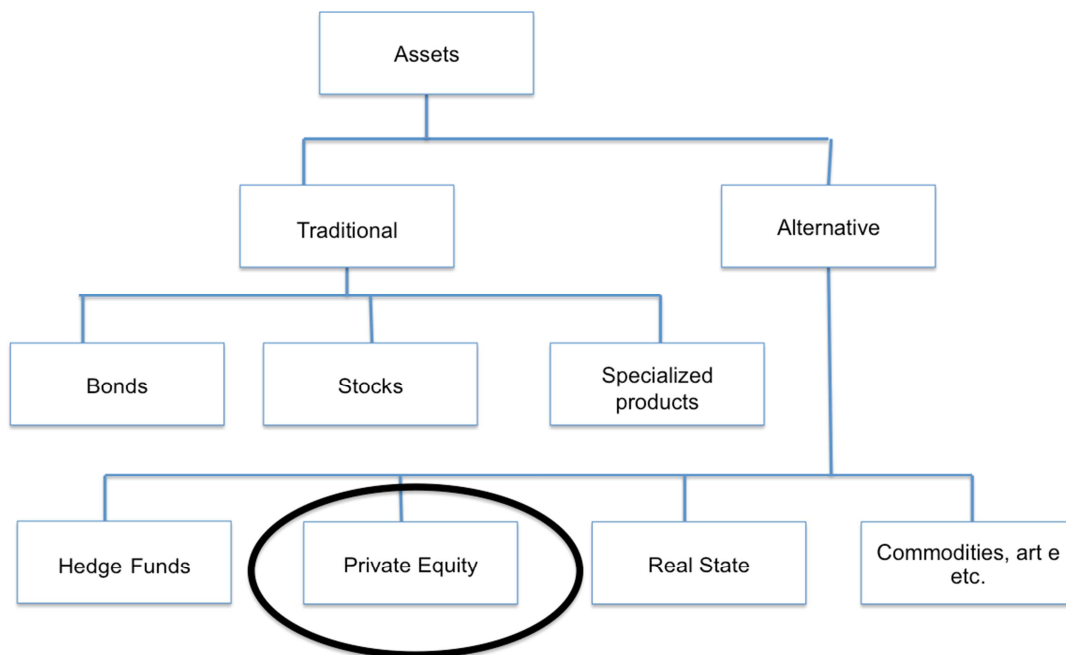
Qualitative analysis is a determining factor at every level of the private equity pyramid of financing. Private Equity is constantly being redefined. Leveraged Buy Out and Private Equity are used interchangeably in the United States, and ends up generating semantic confusion. In addition to that, it is important to point out that information about PE is collected scarcely, heterogeneously and unsystematically. As a consequence it is more difficult to have a precise picture of the industry.

As private equity deals with small and medium sized companies account for most of their activity (the criteria being the size and number of companies being financed), it is highly unlikely that will be a pure and perfect information context any time soon for non listed companies, which happens to represent 99% of the total number of companies. Moreover, Private Equity has been attracting an ever-increasing amount of capital over the course of the last two decades as its visibility has increased. Whenever a company needs financing two solutions would come to mind: stock exchange or bank loans. The first is a limited solution for only the medium to large sized companies, and the second have conditions that are strictly defined.

That are a few characteristics that constitute a private equity deal: financing by an external investor, high risk, high return potential and protection of this competitive advantage. These characteristics form the common ground for all private equity deals (venture capital, development capital, leveraged buy-out, etc.). Another caveat of this transactions are the fact that they are private between parts (non-listed companies). Buy-outs, per instance, transfer the majority of ownership in exchange for cash and are generally friendly. This practice began to spread only recently since it requires sophisticated financial markets and instruments. Private Equity offers investors the opportunity to finance the development of private companies and benefit from their eventual success. (Ellis, 2011)

A private equity investment is usually held from 4 to 7 years. At an early stage of this investment in a given business, the private equity investor must evaluate when and how it will liquidate this investment. Funds are created for maximum 10 to 12 years. In a Private Equity deal there are a range of risks that will vary according to the nature of the situation, per instance, risks will differ if you are handling a creation or if you are engage in reconstructing a business. In a more broad perspective, general risks are subject to the cyclical nature of the business, and also, to the macroeconomic context of the market.

One of the reasons investors may be attracted to Private Equity is that, according to the higher risks it bears, it also contemplates higher returns. This happens when you take into consideration, listed securities. Since Private Equity deals have a longer maturity period, investor will be awarded with a illiquidity premium. Private Equity, alternatively to the stock market, is defined as an alternative asset class, category depicted in the image below.



This definition provides the opportunity to discuss some of the socio-economic consequences, which have emerged with the rise of the private equity sector. For example, in the United States serial entrepreneurs appeared because of the fixed maximum term of investments and high expected returns. Slowly, entrepreneurs have begun to specialize in certain roles such as the creation, the development, the internationalization, the restructuring or the turn around of companies. (Demaria, 2010)

The Limited partnership structure, which emerged in the United States, separated the capital providers and the capital managers, setting a limit to the life of the investment structure without forcing capital managers out of activity. This new caveat was also distributing profits, which were taxed differently and

particularly on a lower level than dividends. Through its investment methods, it was also possible to trace the cash flows and to clearly distinguish the investment refunds from the profits. By separating investment management from capital provision, it was possible to audit the two structures on a stand-alone basis and check if the management was done according to the funds regulation.(Ellis, 2011)

Given the lifetime of a private equity fund (usually 10 years), the risk born by this type of deal; the relative illiquidity of investments, and the need to diversify investments among several funds to apply a sound investment policy, the great majority of limited partnerships (LPS) are subscribed by institutional investors. The legal framework, even if it is important and nice to have, is not enough to guarantee the success if investment structures if economic and social environment is a risk averse. “ *If we learn anything from the economic development, it is that culture makes almost all the difference* “ David Landes (the economist, 2009) Culture is not the only and cannot be the main factor of success of venture capital. (Demaria, 2010)

3.2 Routine of Investees

Private Equity is a long-term, illiquid asset class. The main purpose of Private Equity is value creation. An investment in private equity generally is realized at the general partner discretion. The limited partners are the ones who are going to commit funds upon demand for the GP¹ to invest over a given period of time that may vary. Private equity managers make money by investing in firms, helping management drive growth through active ownership, and then selling their equity stake for a profit later. Whether the investments takes the form of Venture Capital seed funding or buy out of a popular firm, the ultimate aim is to increase the value of the equity stake and then realize the profit. (Demaria, 2010)

¹ General Partner

The enterprise value of any company will depend on the profits that company is expected to make over its lifetime; this means that Private Equity Funds are focused on fostering lasting improvement for the business. In practice PE funds will work with company management to ensure that each investee company has a tailored plan to boost enterprise value. This may often take the form of a tailored operational change program. This program can focus on different aspects of the business such as: the market, the manufacturing efficiency, the design of the supply chain, education and training, finance and cash management and so on and so forth.

Under the governance structures agreed between GP's and company managers, these priorities and the overall change program are regularly reviewed and actively managed. Reputation of investee companies matter, because of the focus on long-term value creation, GP's must be sensitive to any development that could damage the investee company's brand and reputation. Particularly in developing economies and markets, established PE investors from abroad can often be examples of best practice regarding the environmental, social and governance agendas, as well as other sustainability issues. (Demaria, 2010)

Private Equity is an active management model where GP's work closely with company managers on strategy, financial planning and responding to adverse shocks. (Ellis, 2011). General partners will typically speak with company's board, providing more oversight and engagement than in the case of public ownership. This reflects the recognition that PE generates returns by making lasting improvements to business that boost enterprise value; but it also reflects the different incentive structures that are in place compared with other ownership models and asset classes.

In addition to management fees, managers may also qualify for a share of the fund's returns on investments, if those returns are sufficiently high. This performance related pay is known as carried interest or carry. Funds performance is often the ultimately metric by which private investors evaluate their experience of private equity. Private Equity Funds are very concerned

with their both actual and perceived reputation. While past performance is not necessarily a guide to future performance; the past behavior and reputation of GP's should offer a guide to their reliability and honesty. (Demaria, 2010)

3.3 Cycle of Private Equity

The Relationship between Fund and prospective investee develops as follows:

- I) Resources capitation
- II) Investment
- III) Management

How long each one of this cycles take depends on the strategy of each fund. The first stage, which is known as resource capitation objectifies to encounter investors that are willing to insert its resources in a fund, based on the fact that the return on the investments using a fund is higher than if you invest as a stand-alone investor. In this early stage it is also the moment when the strategies for the fund are developed, based on the strategy you will have settled the maturity date, the investee and also the venue where you are going to invest. (Boscatto, 2011)

Lossen 2006, states that the detailed and specific strategy for the fund must be conceived and developed before the capitation of resources phase, that is because you will use the fund portfolio strategy to generate new clients that follow the same perspective. The fund strategy generally should state the number of investees in the portfolio, the diversification levels through time and stages of the investment, and also should mention what different industries are going to be addressed and where are they located. Once the private equity company manages to achieve the targeted investment level for the fund, the fund is developed.

(I) Fund Raising:

It is quite an interesting topic that draws a great deal of attention specially when it comes to the factors that will be responsible for a selection of a fund. The criterion used in this stage is based on: reputation of fund managers, history of returns, and the expectation of similar returns in the future. In some case such as it happens in the United States the Funds have some external assessors called gatekeepers that will help fund managers in the selection of investments. (Boscatto, 2001) On the other hand, these funds have also the assistance of fundraisers that will sell out the fund in the market guaranteeing its reputation and solidity. Players that are already well known in the market and that enjoy good reputation won't need the services of fund-raisers.

II) Investment Proposals:

First the Private Equity Fund has to have access to the company's business plan, in order to analyze its track record, future projects, sustainability, portfolio of products, the market, so on and so forth. In addition to that, the company shall also present an investment plan laying out its financial necessities.

The way funds use to screen possible new business opportunities will occur in of two ways either actively or passively. In the passive manner companies that will pitch an investment approach the Funds, or when doing it actively funds will structure an information network in order to get to know first hand when opportunities are rising in the market, so they can approach the company and negotiate a possible investment.

The second way of making investment proposals are more effective, once the fund managers are already interested in the opportunity; however all the proposals are analyzed even if superficially. In addition to that, we the company is doing a road show for proposals the deal is prone to have more competitors. (Boscatto, 2001)

III) Investment selection

This stage of the process is quite long and requires a great deal of attention, that is the reason some authors tend to divide it into two different phases: proposal of investment and selection of investees. (Boscato 2001.) According to the authors Talmor & Vasvari (2011) one can depict four main points of planning and focus: strategic allocation of actives, portfolio development, fund selection and fund management. Once the fund has reached the investment selection stage, negotiations are going to start; companies will be selected and transaction structured. Generally, funds will try to compose a diverse portfolio of investments in order to reduce their risks and enhance their gains.

The analysis of each investment should take into consideration all the basic aspects of a company, its performance, the quality of its services/products, technological characteristics, the market, its locations, strategic development of the company and more. The selection process is composed by the fund's manager both objective and subjective analysis, whereas in the first screening of the companies on average around 90% of the projects are dismissed. (Boscato 2001 – SAHLMAN, 1990)

In this preliminary analysis the focus will be given to the future prospects of the business, as per instance, the predictions of a certain industry or even the size and kind of company the Funds wants to focus on. The proposals that are still on the run for investments will be deeply analyzed in the due diligence phase. (Boscato, 2001)

3.4 Due diligence

The business due diligence will deeply look to the different environments of the business, both internally and externally. First, the economical environment where the company operates is the focus of the analysis, followed by an assessment of the internal characteristics of the company that may include, the management team, how the process are conducted, the infrastructures of

the company, the human capital side, so on and so forth. This analysis will provide the fund a real overview of the company, with real and update data.

The process of due diligence will continue with a legal due diligence that will focus on the regulatory side of the enterprise, deeply analyzing its contracts, its legal processes and the health of the company's legal environment. This legal assessment is extremely important, because further on the fund will suffer with a return on investment lower than expected if the company ends up having legal disputes that were already signaled before the investment but not taken into consideration by the fund.

It is often the case, that the fund will come up with a contingency plan that will contemplate: a severance package; escrow deposit, guarantee stocks and prices adjustments. However, some companies will not be receptive to this kind of plan. In addition to that, the third step in the due diligence sphere is to look at the financials of the company to analyze solvency, historical track records and more. The fiscal and financial side of the company demands a carefully conducted analysis and assessment, since it can trigger a lot of issues down the road, if mismatches are found.

The process of due diligence is a preliminary activity in order to effectively conduct an investment in a given company. It will serve as a guarantee that the business plan and the financial needs of the company are accurately stated and that the investment is indeed a good decision. Having the due diligence inputs the fund will also have all the information needed to propose action plans and future changes. (Boscatto, 2001)

When assessing which characteristics have influence in the investment decision, the following ones are of major importance:

- Market attractiveness
- Differentiation of the product/service

Some other authors are also going to indicate that the management capabilities are also a crucial feature when deciding to invest in a company.

Fried and Hirsch (1994) mention that there are five different aspects that are generally used when selecting a company to invest: industry attractiveness, project viability, expertise and commitment of the management team, high return possibilities and the mechanisms to exit the investment.

3.5 Private Equity strategic value for the investee

Over the recent years, Private Equity (PE) owned business have become an increasingly important part of the business landscape, ... the growing willingness of major pension funds and institutions to invest in PE reflects the success that leading buyout funds have had over the years. (Acharya, Kehoe and Reyner, pag 4.2008)

PE boards provided much stronger and more effective strategic leadership than plc boards. Generally the respondents of the research would argue that PE boards as leading strategy formulation process, with all the board of directors working together to shape the strategy and define the priority agenda, indeed key elements of this strategic plan are likely to have been laid out during the due diligence process. . (Acharya, Kehoe and Reyner, pg 4.2008)

“PE boards will frequently be the source of major strategic initiatives and ideas, and they have as a role to stimulate the executive team to think more creatively about possible “out of the box” opportunities.” (Acharya, Kehoe and Reyner, pg 4.2008) The role of the executive management team is then to implement this plan, reporting back on progress and highlighting any strategic issues that arise. Also, when it comes to the drive of performance the authors acknowledge that PE play a more attractive and positive role than the Public Sector, since the nature and intensity of the performance management culture and focus is perhaps the most striking different between the two environments.

Investees companies have a great range of positive influences, once they are involved with a Private Equity Fund that will actively engage into its business strategy. In order to better depict the vantages of having this kind of

investment, one can point out three main effects of an investment as such: their effective shareholders are locked in the investment for the duration of the fund, these shareholders are in room with the executive and have a really informed vision about the business realities, and Private Equity Boards naturally have a focus on value creation.

3.6 Private Equity Across Countries

3.6.1 UNITED STATES

The unofficial date of the birth of the modern private equity in the US is in 1958 with the creation of the Small Business Investment Companies, which is a result of a statement by the federal reserve saying “ *In simplest terms, the small business could not get the credit... needed to keep pace with technological advancement*” (Cendrowski, Martin, Petro & Wadecki, 2008) – This statement remains true, and the 2007-2009 financial crises has made it even more obvious, when suddenly liquidity dried up for small and medium sized business, the SBA has been supporting not only the birth but also the growth of young companies, something that Europe still needs. (Demaria, 2010)

The separation of political decision from public funding was the first step of transformation of public action. Public intervention was situated on the incentive site with the help for start-ups and early venture capital firms. Not all governmental actions were in favor of small business. Around the 70'S there were a strong down turn in the IPO's and many investors could not realize its investments. Private Equity suffered under those conditions and their returns were significantly affected – which lead to the Employee retirement act of 1974, to prevent fund managers from taking excessive risks.

The 1st modern private equity initiative was the American Research and Development Corporation of 1946. The success of such initiative would lie in the development of the venture capital industry. Currently one of the challenges in the *venture capital industry in the United States*, is the increasing cost of a start-up. This diminishes the attractiveness of developing

venture capital backed business ideas, and slower the development of the market. (Demaria, 2010) In order to assess the dimensions of the market in the United States, one can relate to the survey done by HIS Global Insight which found that in the US, in 2005, venture capital backed companies represented almost 17% of the national GDP and 9% of the private sector employment. (The economist, 2009)

A couple of years down the road from the financial crisis, and the financial industry is grappling with the realities of regulatory reform, that has developed controls intended to reduce systemic risks. The specific nature of the reforms will vary according to domicile; therefore private equity managers shall carefully analyze the impact of regulatory changes across markets. (Poor, 2012)

The collapse in private equity since mid 2007 can be explained perhaps most directly by the collapse in credit markets and inability to effectively leverage private equity investments. Funds grew too large leading up to 2009, thereby leading to too much money chasing too few quality deals, inefficient due diligence, and too little value- added provided by fund managers. The crisis has brought on increasing calls for regulation of private equity funds (Cummings and Johan, 2009)

In accordance to the pitfalls that have occurred in the United States in recent years, the government decided to create a series of new legislation in order to protect the financial markets. In 2009 it has engaged into the Wall Street Reform and Consumer Protection Act, in 2010 the Restoring American Financial Stability Act of Reforms was develop and a range of new guidelines followed the stricter regulation pattern. (Finley, 2010)

Moreover, a vast part of the new guidance was referring to executive compensation and corporate governance practices that would affect a subset of portfolio companies of private equity, venture capital and other private funds. Accordingly, most analysis of the financial crisis that began in 2007 do not cite private equity funds as a contributing factor. Suspicion was raised

around the activity mostly because the government lacked comprehensive data to which access their activities. Hedge funds are seeing as a part of “the shadow banking system” – which refers to the financial institutions that are beyond the scope of federal regulations, once they are supervised non-bank financial company. (Finley, 2010)

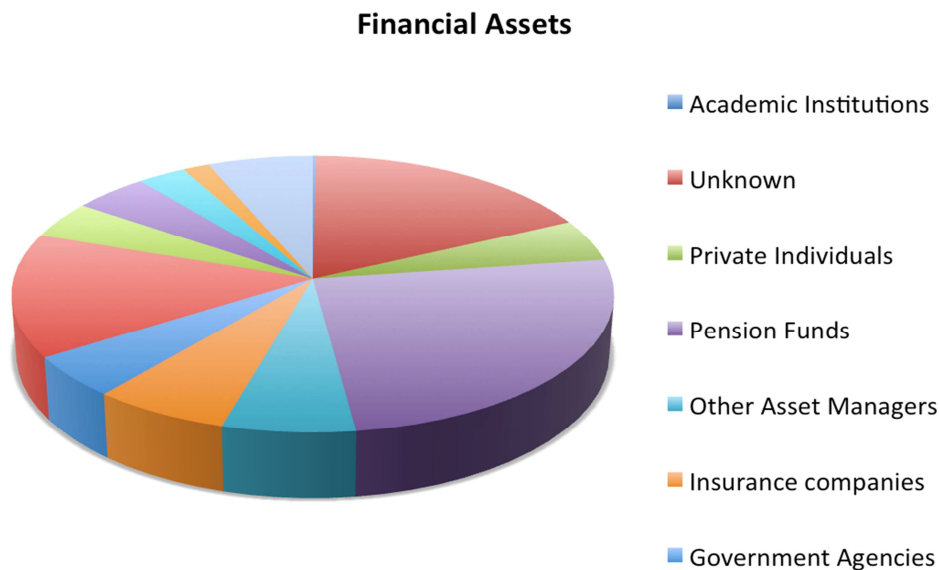
3.6.2 EUROPE

The advent of the European union and the perspective of a pan-European market reinforced the conviction that European companies could compete by applying a successful foreign model. This conviction ignores the fact that culture plays a major role in innovation. The Risk prone population like the one in the US cannot be compared to risk averse populations in Europe, the reason for this differences are numerous and deep rooted. “*Europe is actually leading the US in innovation and technological developments but these innovations rarely go on to be a commercial success*”

Local Venture Capital Firms are eagerly trying to spot opportunities. European Venture Capital Investments 23% growth on average in Europe (2003-2006), against only 0,3% in the United States. (The economist, 2009) It is important to highlight that these funds are allocated merely on a local basis not taking advantage of the EU scale. Venture capital foster economical growth for the next 15 to 20 years. In order surpass the industry national borders and establish a truly pan-European scale the EU has to transform 4 obstacles into assets: a fragmented market; the strong risk aversion of its population, a recurring lack of immigration and the lack of direction for the industry.

The size of the capital market also plays a role in monetizing innovations and technological development. In addition to that in all the markets to be analyzed one must take into consideration, *governmental Inputs*: legal changes, tax rebates infrastructures. Each nation has adopted some ideas coming from the United States such as: limited partnership, SBIC system (to generate local national support for its start ups) that acts similarly to BNDES in Brazil.

According to the European Private Equity and Venture Capital Association (EVCA), in 2008 banks represented 6.3% of the 79.6 EUR collected by private funds in Europe, ranking after pension funds (25.2%) funds of funds (14.5%) and insure companies (6.6%). Figure 1.1 shows the breakdown of Private Equity in Europe.



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In terms of taking the lead in the continent, the United Kingdom has imposed itself as a model market for PE capitalizing on the influence of its financial center, its cultural and linguistic proximity with the United States and of course a tradition around innovation. – London would be the location for the headquarters of this industry in Europe. Adversely, France has tried to go its own way, combining public initiative with semi-private financing. The (*Sociétés Régionales de développement*) SRDD created in 1955 to nurture local ventures. The initiative was highly costly and as a consequence eventually failed but it educated French investors and prepared them for the emergence of independent funds. Moreover, Modern venture capital in Europe was initiated by major changes generated by the adoption of the general/limited partnership agreement. (Demaria, 2010)

The UK has its own version of the US limited partnership structure. France adopted the framework to the local law by creating the *Fond Commun de Placement a Risque FCPR*. In many respects European countries have set a specific tax framework for capital gains, as well as a defined term in order to encourage investors to invest in venture capital firms. Additionally, EU adopted best practices from the US, but only recently was able to attract international limited partners. Until 2001 the returns on the US were looking significantly more appealing than in Europe for a given level of risk. However, more recently due to the crisis in the North American financial system, European venture capital managers have taken the lead in the fund raising scene. Nonetheless, it is only a fraction of what is raised by the Americans.

The United States is experiencing 4 different factors that have not yet reached Europe: 1st the amounts raised by existing and emerging venture capital managers have increased very quickly – this had an impact on the valuation of portfolio companies, which as a consequence has increased. 2nd the cost of creating a company in the United States was increasing comparatively faster due to the scarcity of talent and space in the right location. 3rd the exit scenarios of venture capital investors relied increasingly on IPO's, which eventually failed to materialize. 4th the returns dropped significantly as a consequence of the first three effects. (Demaria, 2010)

Europeans start-ups on the other hand were cash starved for potential investors, cost remained relatively low, talent was available as well as space at a much cheaper price; IPO's are rare in Europe for venture backed start ups. Accordingly, many companies entered the European market from 1997-2003, such as Yahoo and Ebay. Despite the EU legal convergence, national laws remain as an entry barrier on the national markets. There is a lack of common practices in corporate law, even though the European corporation has existed officially since 2001, and was adopted by member's states progressively. The innovating processes in Europe are the result of a common cultural background and national differences.

Europe has reached a first level of maturity when it comes to the venture capital market, however the situation varies across the continent. UK, France and Scandinavia are the most advanced markets. The challenge in Europe is to offer a way for lagging the markets to catch up with the most advanced market and at the same time develop an European platform in order to gain competitive advantages and leadership in certain industries. Europe lacks the entrepreneurial spirit that is a characteristic of the United States. Culture is one of the main factors, which are holding back private equity in Europe, but it is certainly not the only one: to this effect, economic policies and openness to immigration are important too. (Ellis, 2011)

In the next couple of years roughly half of investors expect to sell US Private Equity and 35% intend to sell Asian ones. This proportion stands a staggering 76% for European assets, according to recent research presented by Francois Aguerre of Coller Capital. “ The Prominent UK and French markets continue to be fuelled by banks and insurance companies, whereas public pension funds represent the largest category of sellers in the US” (Nicholas Lanel, managing director and head of European Secondary Market Advisory at UBS.

3.6.3 Emerging Markets

Emerging markets, despite their social and cultural eagerness to take risks, are still lacking fundamental elements such as transparency, rule of law, and fair business practices – including the application of the economic policies and regulations. This development is crucial for building a long-standing private equity environment, and benefiting from its impact. The rush to emerging markets has anticipated this fragile evolution and may shake up shy local initiatives (Demaria, 2010)

The importance of political sponsors is much too significant in emerging markets, and Latin America is one part of the emerging markets that has still to emerge as an active source of deals, specially when it comes to LBO, however, we can see that Brazil has already began to structure its Private

Equity Market. The main question concerning both emerging markets, especially Brazil and also Europe is, in which extent the US venture capital model can be successfully adapted to other countries? (Gompers and Lerner 2002)

3.6.4 Private Equity In Brazil

The Brazilian Private Equity and Venture Capital Sector has accumulated more than 2 decades of experience, making it possible to examine the industry and its entire cycle. (Ribeiro e Carvalho, 2007) Empirical studies have shown that the PE/VC industry has evolved very differently across countries (Jeng and Wells 2000) and within countries (Gompers and lerner 1998) Megginson (2004) found that the differences in design of the PE/VC industry are due to institutional factors, with the legal system of the country

In the recent years there has been a sharp increase in buy-out acquisition of publicly- traded companies. In the United States and Europe Private Equity companies face greater competition due to the more complex financing market and the oscillation in these highly developed markets. Many of these actors are pursuing higher returns through portfolio investments in emerging markets.

Historically, if you look at Brazil and other Latin-American countries they have not attracted financial investors due to a range of issues, generally related to economic, legal and regulatory environment. Until some years ago the Brazilian picture where composed by excessive inflation, staggering interest rates, limited exit alternatives, deficient corporate governance standards, foreign ownership restriction and a clouded legal and regulatory landscape. (Angus & Pargendler, 2008)

Today Brazil within its institutional limitations offers a better scenario for investors to penetrate the market and realize expected returns within a realistic time frame. There has been significant improvements in the country's business landscape, including: economic environment, regulatory and legal

regimes and active local markets. Those factors are fostering more investments in Brazil by Private Equity Foreign investors.

The combination of low inflation, falling interest rates and a stable economic policy has lead Brazil to achieve its best credit rating in history in the year of 2007. These macroeconomic changes, coupled with a number of investor friendly improvements and the development of capital markets has made Brazil an attractive investment option for Private Equity Sponsors looking for opportunities in Emerging markets. (Angus & Pargendler, 2008)

Among the BRICs Brazil is especially well suited in terms of general infrastructure and legal framework required for successful private equity investment. The success experience in the Brazilian market has permitted the expansion of local players, as illustrated by the 2007 US\$ 1.0 billion leveraged buy-out of Pride International drilling and E&P services by GP investimentos, a Brazilian private equity firm.

In spite of Brazil position in Latin America, it is still highly underserved by the private equity market compared to other BRIC's countries. Investments in Brazil still involved enhanced risks for foreign investors. Private Equity managers need to understand: the full nature of their investment, the skills and scope of a portfolio company's management team, the operating conditions and the legal and regulatory framework in Brazil applicable to their portfolio company.

Until recently PE² companies in Brazil would face a long holding period for its portfolio investment. In many cases a PE investor would combine its Brazilian investment with other regional or international assets in a sale to a strategic buyer as the only available option. The development of stable and diversified capital markets in Brazil has dramatically increased the liquidity of private equity investment in the country by turning IPO's into an attractive alternative. (Angus & Pargendler, 2008)

Private Equity backed investments played a key role in Brazil's recent wave of IPO's. More than half of Brazilian's IPO's in 2006 represented an exit

strategy for private equity sponsors. Over the last couple of years, a Brazilian company undertaking an IPO would generally conduct both a Brazilian and an international offer to institutional investors following the rule 144A and Regulation S under the US securities law with a listing on the Bovespa. – Some Brazilian companies listed abroad and followed the SECEX protocol, while others listed only in Bovespa. The continued development of the Brazilian capital markets has in most cases made a U.S listing or registration with the SEC unnecessary for a Brazilian portfolio company, as institutional investors have invested heavily in Brazilian assets trading on the local markets. (Flesch and Prado, 2008)

In 2001 the Brazilian law that regards to corporate governance was amended. The Brazilian corporate law (lei das sociedades anônimas) included several new protective measures to minority shareholders. (The reduction of the proportion of preferred non-voting stock that may be issued and tag-along rights to minority common stockholders at a price equal to 80% of the price paid to the controllers in case of a sale control.) However, the major improvements did not arise from regulatory requirements but from the voluntary adoption of stricter corporate governance standards than those required by law. This voluntary initiative aimed to increase investor confidence and improve returns.

Is the success of the voluntary listing on the Bovespa (level 1, level 2 e novo Mercado), which requires compliance with even stricter corporate governance standards than those required under the amended Brazilian corporate law. In particular companies wishing on to list on to novo Mercado must abide the following rules: (Flesch and Prado, 2008)

- Issuance of a single class stock (no no-voting preferred stock)
- Unified term for board members (No staggered board of directors)
- Minimum 25% of the corporation's issued stock in circulation
- Compliance with either USS GAAP³ or IFRS⁴

- Minimum 20% of directors of the company's board must qualify as independent directors
- Tag-along rights allow minority shareholders to receive the same premium paid to controlling shareholders in an event of change of control
- Mandatory bid for all shares in circulation, in case of opting out of the Novo Mercado or delisting from Bovespa, and
- Mandatory arbitration for resolution of corporate disputes

These Novo Mercado Innovations brought more transparency and minority protections for the financial market, translating into a trade premium for the stock of *Novo Mercado* Companies. A range of companies that are not listed in the Novo Mercado, have nonetheless adopted some of its regulatory measures. The success of the *Novo Mercado* and general increase in the Governance standards depth and transparency in Brazilian capital markets provide private equity funds an invaluable exit platform for their portfolio company investments.

Even though investment rates have decreased in Brazil in the last couple of years, debt financing remains expensive for Brazilian companies. Extraordinary high interest rates paid by the Brazilian government bonds in the recent years, banking lending spreads remained extremely high during this period due to various factors such as: the credit risks associated with the judicial enforcement of contracts, high mandatory reserves requirements, absence of competition on the debt market and macroeconomic factors have worked against the development of a local debt financing market that could foster a attractive Private Equity sector with the features found in advanced financial markets. (Flesch and Prado, 2008)

As a consequence while Private Equity Funds may have to look beyond the strategies they use in developed markets, when evaluating Brazilian investment opportunities, more often than not, they may be able to offer attractive financing and investment alternatives for many sellers and portfolio companies. Leveraged buy out which is typical in the United States has not already spread out in Brazil due to the high cost of debt in the country. In

Brazil many PE sponsors have relied on earnings and building equity over the long-term to realize returns on their Brazilian portfolio investments.

There has been a steady and consistent decrease in Brazilian real interest rates, interest rates paid on Brazilian government bonds, and increased confidence in the country's economic stability is leading to significant changes in the financing alternatives available to PE Funds. (Once there has been only the BNDES) The increasing role of international private equity funds in the Brazilian market is changing the landscape of the private equity industry in Brazil. As interest rates continue to decrease, LBO's and other strategies involving local debt may provide greater opportunities for funds seeking to acquire a Brazilian company. (Flesch and Prado, 2008)

In the past it was common for Brazilian companies to have very high levels of ownership and voting concentration, normally in the hands of the founder's family groups thus leaving most investors with minority stakes and without any significant influence in the company's governance. With the 2001 Brazilian corporate law reforms, a Brazilian company was authorized to issue up to 2/3 of its capital as non-voting preferred stock, a percentage that was reduced to 50% on 2001 The development of the *Novo Mercado* companies, coupled with the spontaneous adoption of practices promoting ownership dispersion, is facilitating a deep structural change in the ownership patterns of Brazilian companies. (Flesch and Prado, 2008)

As a result, widely held companies, a phenomenon unheard of in the Brazilian modern corporate history, are now emerging, which opens to private equity sponsors and other acquirers a host of new investment strategies. A Brazilian company with dispersed ownership can become a target of unsolicited tender offer, making private equity acquisitions and combination transactions with strategic industrial partners easier to implement. The dispersed ownership model fostered by the *Novo Mercado* strengthens the role of management, which may eventually lead to the emergence of private equity sponsored buyouts in the Brazilian market.

In many instances, private companies once acquired tend to delist from Bovespa. For several reasons such as: from a liability and financing standpoint, a PE investor may be reluctant to continue with minority shareholders in public company having continuing reporting obligations after it has acquired a significant majority of the outstanding shares. De-listing requires a “going-private” tender offer at a price economic value of the shares, as determined by an appraiser selected by the board of directors and shareholders of the company. For the “going-private” tender offer to be successful, at least two-thirds of the outstanding public float on the *Bovespa* must tender or expressly consent to the de-listing. (Flesch and Prado, 2008)

A private equity Fund can combine the mandatory “tag along” tender offer and the “going private” tender offer in a single tender offer with the prior consent of the Brazilian securities regulator (CVM) under certain circumstances. A single tender offer would reduce transactions costs and increases the probability of a successful completion of a going private transaction as compared to a dual-phase strategy. In order to build-up takeover defenses widely held companies can make use of something called as poison pills, Brazilian style poison pills establish a fixed mandatory premium to be paid by any bidder (hostile or not) to all shareholders in the event of an acquisition of control of a company.

These takeover defenses have yet to be tested in Brazilian courts. If faced with the issue, it is unclear whether a Brazilian court would embrace a model of board control over the sale process and permit the liberal use of takeover defenses, as it is the case in the United States, or would instead discourage takeover defenses and allow shareholders to decide directly on the merits and viability of an unsolicited offer. A private equity sponsor looking for making an investment in Brazil should be quite careful and undertake a comprehensive legal due diligence investigation and a the throughout analysis of the regulatory implications of a given transaction.

The key issues surrounding the private equity in Brazil are expressed as follows:

Tax	Brazil has one of the biggest tax burdens in the world, which requires significant ongoing management resources. A detailed review of a portfolio's company tax record is something that needs to be carried out in this environment, in order to avoid penalties.
Labor	Brazil has very strict labor laws and there must be a deep analysis of the employment records of a company.
Antitrust	The antitrust process in Brazil can be lengthy in comparison with the one's in Europe and in the united States. Brazil law does not require an antitrust receipt prior to the completion of a transaction but it is subject to it afterwards. This process in regulated by CADE (<i>Conselho Administrativo de Defesa Econômica</i>)
Foreign Investment	The Brazilian laws are becoming more and more welcoming to foreign investment. These investors must register with the Central Bank. There are no restrictions over the repatriation of capital; however, capital gains are generally subject to 15% income tax. Private Equity sponsors should realize that control acquisition involving related industries such as energy and telecommunications, as well as other government concessions, still requires the applicable Brazilian government authority. Although the political environment currently favors foreign investment, the risk associated with governmental approvals must be taken into account in the early stages of the transaction.
Enforcement, jurisdiction and arbitration	The judiciary process in Brazil remains extremely low due to the relatively low cost of litigation and appeal. Arbitration has gradually become a popular method for the resolution of corporate disputes in Brazil, since the enactment of the 1996 Arbitration Act (<i>Lei de Arbitragem</i>). Arbitration of corporate dispute is mandatory for companies listed in the <i>Novo Mercado</i> . PE sponsors should seriously consider the addition

	of arbitration clauses in their agreements once dispute resolution would be faster and more effective than in the Brazilian judicial system.
Environment Issues	Environmental due diligence must verify whether the company possesses all required operating licenses and whether it has conducted its activities in compliance with the applicable environmental regulations. Liability for environmental damages has increased significantly in recent years with the enactment of the environmental legislation in Brazil.
Local Presence	Foreign firms operating in Brazil are required to obtain government authorization and maintain a local representative all times.

The acquisition of a public company is not subject to fiduciary duties (approval or recommendation of the board of directors), which is adopted in the United States. Brazilian corporate law lays on several duties to the controlling shareholders that must be respected. Controlling shareholders must: control the company's corporate purpose and social function, discharge their duties to the company's minority shareholders, employees and the community surrounding the business and indeed may be held liable for actions that may constitute an abuse of corporate control.

When doing business with a company in Brazil a Private Equity investor must enter into agreement with other shareholders of the company who will provide clear mechanisms and rights with respect to governance, voting, financing and raising of additional capital, exits and dispute resolution. They should also look for an effective drag-along mechanism so the investor can negotiate the sale of the portfolio company and afterwards convince other shareholders to sell to the chosen buyer. The key for the Private Equity Foreign investor is to make sure he will be able to implement the mechanisms agreed to in the shareholders agreement and in the Brazilian portfolio company organizational documents. A shareholder agreement of a Brazilian portfolio company is generally governed by the Brazilian law, therefore legal counseling should be

involved early in the process to ensure the agreed upon mechanisms and rights are properly structured under applicable law. (Flesch and Prado, 2008)

Private Equity Funds should be aware that there are enhanced risks when they are placed as minority shareholders in Brazilian companies. There are in fact a number of protections for minority shareholders of Brazilian companies which are public traded, however going opposite of what happens in the United States in Brazil there is a lack of settled law for minority shareholders in closely-held corporations. Which enhances the need of a carefully drafted shareholder agreement that should include protection mechanisms such as: Rights of first refusal, tag along rights, specific buy-outs provisions and supermajority voting and veto rights, as well as, ensure board representation in order to facilitate monitoring of the business and preservation of voting rights. Voting and shareholder agreements and shareholder agreements are very usually respected under the Brazilian law.

Private Equity/ Venture Capital Funds in Brazil, generally considered a type of investment fund, have some specific characteristics established by the Brazilian securities commission. The regulation (CVM 391) issued in 16, July 2003 regulates the incorporation, management and operations of Investment Funds. One of the main characteristics of a Brazilian private equity fund is that it participates in the decision making process of the relevant company, notably through the appointment of members in the board of directors. (Flesch & Silva Prado, 2008)

The fund will participate in the decision making process of the relevant company, weather:

- a) Holding shares that are part of the controlling block
- b) Entering into shareholders agreement
- c) Executing other agreements or adopting procedures that assure the effective influence of the Fund in the company's management or strategic policies.

Funds objective is to aggregate value to the portfolio companies through management directions. CVM Regulation 391 allows funds to invest in

companies under a recovery or restructuring process. Funds are a tool to gather proceeds and enhance companies. The Funds shall be organized as a closed-end condominium with a determinate duration term. The quotas issued by a Private Equity Fund may only be redeemed upon liquidation of the fund; and the Regulation that incurs upon funds shall provide the criteria and conditions for amortization of the quotas.

There are a range of actors that can invest in Private Equity Funds, they are: financial institutions, insurance and capitalization companies, private pension funds, individuals or corporations with their own investment of at least R\$ 300.000,00, investment funds designed exclusively to qualified investors, portfolio managers and securities consultants licensed by the CVM and; employees or partners of managing institutions, provided that they are authorized.

Each Fund Regulation will determine the criteria to indicate what public – held company are eligible to receive its investments. Non-public companies have to follow a list of different criteria in order to be eligible to receive PE investment, the main criteria are as following: prohibition as to the issuance of founders shares and redemption of those in circulation, unified term of office of one year to all members of the board of directors, disclosure of related party agreements, shareholder's agreements and stock option programs; adopt arbitration procedures to solve corporate conflict, if the company decides to follow an IPO adopt to the requirements of the *Novo Mercado*, annual audit of its financial statements by independent auditors registered with the CVM.

Once one's look to the structure of the management within a PE Fund it can perceive some general characteristics: the quota holding's meeting, the administrator and the manager the same entity may act as administrator and manager. The Fund may also have an investment committee and an advisor. The quota holding's meeting is the main decision-making body of the fund. It has to be called at least 15 days in advance by the fund's administrator or

holders of at least 5% of the funds quotas, observing the procedures for convocation established in the FIP (FUND) regulation. Meetings with full attendance are considered properly called. Each quota entitles its holder to one vote at the quota holders meeting and the votes may be given in person or per proxy.

The Quota holders meetings shall: approve the financial statements of the fund presented by the administrator and shall decide on: (i) Amendments to the Fund regulation, (ii) appointment and removal of the administrator, (iii) merger, spin-off and liquidation of the fund, (iv) issuance of new quotas, (v) increase of the administrator fee, (vi) extension of the fund's term, (vii) amendments to installation and deliberation quorums of the quota holders meeting, (viii) creation and operation of committees and councils, and (ix) disclosure of certain information requested by quota holders. The decision of the quota's meeting relies on the majority of quota holders vote but is legible to a few exceptions.

The administrator is the entity liable for the organization and management of the Fund and for the controlling and maintenance of its accounts. The manager shall: identify investment opportunities (detailed and broad analysis), actively manage the investments made with the caveat of enhancing return on investments. Both the administrator and manager shall be a corporate entity authorized by the CVM to perform management of portfolio activities. The administrator shall appoint an officer or partner liable for the representation of the Fund towards the CVM.

Among administrator other obligations established by the CVM Regulation 391, the administrator shall provide to holders of 10% of the quotas, as required by these holders, the investment studies, and analysis prepared by the administrator or the manager who bases his decisions on those made in the quota holders meetings and on any updates of such studies and analysis allowing the follow-up on the investment made. CVM regulation 391 also restricts certain acts to be taken by the administrator on behalf of the fund, such as the obtaining of loans, the granting of guarantees and liens, investing

abroad and in real state, negotiating with trade bills and promissory notes to assure pre-determined returns to investors.

In order to set up the FIP is necessary to register its incorporation acts before the Registry of titles and deeds office (*Cartório de Registro de Títulos e documentos*) of the city where the FIP has its head offices. These incorporation acts must provide at least for:

- FIP's Regulation, which establish the basic rules applicable to the operation and administration of the fund; and
- The appointment of the fund administrator, together with a written statement in which the administrator accepts his or her appointment therefrom.
- After filling the incorporation acts, one should register the Fund with the Brazilian Federal Taxpayer's Registry of the Ministry of Finance. CNPJ
- Law n° 11.478, dated 29 may, 2007 created the FIP infrastructure design to allow investment in energy, transportation, water, sanitation and irrigation projects through special purpose companies.
- The infrastructure FIP is part of the economic acceleration plan currently being implemented by the Brazilian government and is offered as an opportunity to enhance investments in infrastructure.

The investment in quotas of a FIP is considered as a portfolio investment known as 2,689 investment which was established by the national monetary council's resolution n° 2,689, issued on January 26, 2000. It regulates the application of funds from abroad by a non-resident investor in the financial and capital markets. These investors both individuals and collectively are the "natural person or legal entity", the funds or other collective investments entities, that are resident, headquartered or domiciled in a foreign country." The financial operations resulting from the applications referred to by resolution 2,698 can only be executed upon a foreign exchange contract, as set forth by the legislation in force. (Flesch and Prado, 2008)

Prior to its activities in Brazil, the foreign investor must meet some requirements, such as: constitute one or more representatives in the country that can be held liable with the authorities, Fill the form attached to resolution 2,689, that aims to identify and qualify the investor, the representative, and the co-representative, as the case may be, in addition to the fiscal conditions and declaration from the investor, and also; obtain a registration with the CVM according to CVM regulation n° 325, issued on January 27, 2000.

Regulation CVM 325 states that the investor shall obtain a registration with the CVM through his or her representative, who must send to the CVM, by electronic means, the information of the attachment to the resolution 2,689. In addition to that the investor should execute an agreement regarding the custody of the negotiated securities with an entity authorized by the CVM to perform such services.

These funds are also subject to the registration with the central bank. The aforementioned regulations also contain additional administrator obligations with which he or her must carefully comply. Any funds in Brazil under the regime established by resolution 2,689 can also be invested in other financial operations, which assets, according to their nature: (i) are registered, under custody or maintained in a deposit account in an institution or entity authorized by the Central Bank of Brazil or CVM to perform such services; or (ii) are duly registered in registration, liquidation, and custody systems, recognized by the Central Bank or authorized by the CVM, as the case might be. Among other restrictions provided by Resolution 2.689 regarding the application of funds in Brazil, any transfer or assignment abroad of investments owned by the investor done otherwise as expressed by Resolution 2.689 is prohibited, except in cases of transfer originated by mergers, acquisitions, dissolutions or by hereditary succession.

Because a FIP is not considered a separated legal entity, it is not subject to corporate taxes, which means that income received by the FIP's portfolio is not subject to the income tax. The taxation occurs when the FIP transfer the

income to the quota holders. This taxation will vary according to the form of remuneration and composition of the portfolio. (Flesch and Prado, 2008)

In regards to the taxation of the quota holders, regulation implies the following: dividends paid to the quota holders are not subject to withholding income tax in Brazil. Interest on net equity received by quota holders would be subject to the withholding income tax at the rate of 15%, gains earned by the quota holders in the redemption of quotas of the FIP, would be subject to income tax at the rate of zero, provided that: (a) the quota holder holds less than 40% of the interest in the FIP, (b) the FIP's portfolio must not hold debts bonds in an amount greater than 5% of its net worth, except public bonds, and (c) investors must not be resident or domiciled in a country or location that does not impose income tax or where the income rate is lower than 20%.

The legislation establishes that neither the quota holder nor its related companies may hold more than 40% of the quotas of a given FIP in order to benefit of the item.

In order to benefit from the zero income tax rates in the redemption of quotas, the foreign investor in an FIP must be registered in Brazil. *"International Private Equity Firms are flooding back into the Brazilian market, lured by stellar returns and easy exit opportunities."* (Mitchel, 2011) Around the mid 90's the foreign investor specially the ones in the industry of private equity have been lured to the Brazilian market due to the vast potential of the domestic economy, the currency relationship between real and dollar, as well as, the market oriented policies that had been implemented. However, due to the rise of deficit and the devaluating of the currency in 1999, most of the players in the domestic industry were burned; and international firms moved away from the country.

Currently, there has been a shift in the position and money has been coming to Brazil. The economy has been developing in a sustainable upward trajectory, due to the market-friendly policies that have been adopted during the past few years. The regulatory environment allows domestic pension

funds to invest in Private Equity and provides tax exceptions for foreign investors, which encourages the industry expansion.

- Enjoys support from BNDES (state-owned development bank).
- And also support from the Financiadora de Estudos e Projetos. (State run foundation for research and development)
-

In addition to what was mentioned earlier, Brazil has also a vibrant corporate sector (15.000 companies with annual revenue greater than 150 million) providing plenty of investment targets according to Advent International. There is also the buoyant market for initial public offerings that facilitates the exit of Private Equity investment. “ *A sustainable PE industry requires the right ecosystem.*” Janusz Heath Senior Investment Manager at Capital Dynamics.

“ Today Brazil has many of the necessary ingredients in place: strong, active pension funds; a sound regulatory environment; government support; dynamic capital markets; and an increasing pool of professionals and experienced PE managers”

Brazil is now the second-most attractive emerging market for private investors, just behind China. These global investors are hoping to duplicate the stellar returns that Brazil’s domestic companies have generated in the past 10 years. Even though most of the foreign players have withdrawn from the market before, local players have remained committed, focused on modest investments, in medium sized companies. “ For PE investors, Brazil has the best risk-adjusted returns of any BRIC country” – João Teixeira – Head of the São Paulo Office of GTIS Partners. The key question for investors is whether the industry can continue to produce those kinds of returns.

“ There is a growing concern about overvaluations, especially for bigger-ticket deals” – Frederico Greve, Managing Partner at DGF Investimentos. “ But in the middle market we don’t see so much pressure on prices”. *Firms can also improve their chances of success by sourcing deals outside the industrial*

triangle of Sao Paulo, Rio de Janeiro and Belo Horizonte, where the economy is showing signs of overheating and valuations are the highest. "(Flesch and Prado, 2008)

A potential shortage of Investment professionals could also slow the industry's growth – local staff to generate deals, it is very hard to find the right people. In some cases there is a sense of drift-vu, where fly in investors are entering it, don't really understand local conditions and are pushing up valuations. A number of factors are compounding the problem: the Brazilian stock market has risen to very high levels, private equity funds investing in the country are now of a bigger size, and there is a huge amount of international liquidity available, enabling foreign PE managers to invest in the Brazilian domestic market.

Most players are confident that the industry has still a lot to grow, since it remains relatively small in face of international standards. (Total investment equals 0.23 percent of the domestic product, while in china its number is 0,16, in India 0,44 and in the United States 0,90). Figures according to Empea. PE players in Brazil operate with very low leverage due to the country's high interest rates. It is a different model and presents less risk. In this scenario private equity players need to make strategic or operational improvements rather than relying on financial engineering. (Cláudio Furtado, Executive Director of the Center for Private Equity and Venture Capital Research at FGV, a Brazilian think tank).

The industry has a sound domestic footing thanks to a range of regulatory moves facilitating Private Equity Investments by Brazilian Pension Funds. In 2003 the introduction of fundos de investimentos em participações, known as FIP's. Around 2009 The Comissão de Valores Mobiliários, Brazil's securities regulator, simplified its rules to make it easier to create FIP. Brazil's National Monetary Council liberalized its rules to allow closed pensions funds (those tied to employees of a specific company) to invest up to 20% of their assets in Private Equity and venture funds. Largely as a result, Brazil Pension Funds account for one quarter of the capital raised by Private Equity Funds.

“ Pension funds gave the industry a huge boost in the US in the 80’s and now they are doing the same in Brazil” - Cate Ambrose – President of the Latin American Venture Capital Association.³ sectors those are highly prominent in Brazil consumer sector, property development and infrastructure. (The advantage of this type of investment, which has the time horizon of three to five years, is that 75 to 80 % of the capital cost is financed by the BNDES).

Premium for control is too high in Brazil. What was critical to this deal was the governance we were able to negotiate with the main Banks”. So far more than 550 Brazilian companies have received venture capital or private equity investments. (FGV) A robust IPO market is helping to sustain the industry’s growth by ensuring that fund manager can make timely exits from their investments. “As the Brazilian Market matures, private equity firms are likely to shift from growth – oriented deals to more conventional buy-outs.” Heath – Capital Dynamics. “ The private equity industry’s development across countries tends to *follow* the same pattern It starts with what gets called “ Venture Capital” essentially backing earlier stage and smaller business, followed by growth capital, and then a buyout market develops. (Jason, 2011)

3.7 Global Expansion of Businesses

Once Global companies decide to expand their business they need to access the risks, rewards and actual attractiveness of a foreign market. In order to do so it is important to access the different types of distances one can find between the headquarters country and the subsidiary country. Therefore Ghemawat, came up with a tool package that can help managers to analyze distance between countries and how they will affect activities in different sectors of the industry. In his analysis there are four different types of distance: cultural, geographic, administrative and economic. These specific types of distance will influence business in different ways. As example, geographic distance will affect the costs of transportation and communication, whereas, cultural differences will affect consumer's product preferences. (Ghemawat, 2001)

The Cultural distance, per instance, determines how people interact with one another and with companies and institutions. Per instance: different religious beliefs, race, social norms, and languages are all-capable of creating distance between two countries, and therefore have a huge impact in business relations. In addition to that, administrative and political distance represents the historical and political associations shared by countries. As examples, trading agreements, common currency and political union affect greatly business relations among countries. “ *The integration of the European Union is probably the leading example of deliberate efforts to diminish administrative and political distance among trading partners.*” (Ghemawat, 143) National unilateral measures, such as protectionism, can also create administrative and political distance. Those kinds of policies post the most common barriers to cross boarder competition. (Ghemawat, 2001)

In some cases the difficulty arises in a company's home country, however, the problem is most commonly found in the target country, that will impose barriers such as: tariffs, trade quotes, restrictions of foreign direct investment, and preferences for domestic competitors in the form of subsidies and

favoritism in regulation and procurement. Moreover, corruption and social conflicts, will depress trade and investment far more than any explicitly administrative distance or policy restriction. When a country institutional environment is strong, per instance, if it has a well functioning legal system, it is much more attractive for outsiders. “ *A target country’s weak institutional infrastructure can serve to dampen cross-border economic activity*” (Demaria, 2010)

The Geographic distance will affect generally transportation and communication cost and infrastructure. A recent study indicates that cross-border equity flows between two countries fall off significantly as the geographic distance between them rises. This phenomenon can be explained by the level of information infrastructure (crudely measured by the number of multinational banks branches, telephone traffic and so on) accounts for much of the effect of physical distance in cross-border equity flows. (Ghemawhat, 2001)

The Effects of economic disparities affects the cost and quality of financial, human and other resources. Companies that rely on economics of experience, scale and standardization should focus more on countries that have similar economic profiles. That is because they have to replicate their existing business model to exploit their competitive advantages. – Which is hard to pull off where costumers incomes and quality of resources are very different. Therefore, Cross-country complexities place a premium in responsiveness and agility. (Ghemawhat, 2001)

In the picture bellow, one can observe the different caveats of CAGE and how they affect different sectors of businesses.

	Cultural Distance	Administrative	Geographic	Economic
Attributes creating distance	<ul style="list-style-type: none"> • Different languages • Different ethnicities; lack of connective ethnic or social networks • Different religions • Different social norms 	<ul style="list-style-type: none"> • Absence of colonial ties • Absence of shared monetary or political association • Political hostility • Government Policies • Institutional Weaknesses 	<ul style="list-style-type: none"> • Physical Remoteness • Lack of a common boarder • Lack of sea or river access • Size of Country • Weak transportation or communication links • Differences in climates 	<ul style="list-style-type: none"> • Differences in consumer incomes • Differences in costs and quality of: • Natural resources • Financial Resources • Human Resources • Infrastructure • Intermediate inputs • Information or Knowledge
Industries or products affected	<ul style="list-style-type: none"> • Products with high linguistic content (TV) • Products affect cultural or national identity of consumers (food) • Product features vary in terms of: • Size (cars) • Standards (Electrical Appliances) • Packaging • Products carrying country specific quality associations (wine) 	<ul style="list-style-type: none"> • Government involvement is high in industries that are: • Producers of staple goods (electricity) • Large employers (farming) • Large suppliers to the government (Mass Transportation) • National Champions (aerospace) • Vital to national security (telecommunications) • Exploiter of natural resources (oil, mining) • Subject to high sunk costs (infrastructure) 	<ul style="list-style-type: none"> • Products have a low value-to-weight or bulk ratio (cement) • Products that are fragile or perishable (glass, fruit) • Communications and connectivity are important (financial services) • Local supervision and operational requirements are high (many services) 	<ul style="list-style-type: none"> • Nature of demand varies with income level (cars) • Economies of standardization or scale are important (mobile phones) • Labor and other factor cost differences are salient (garments) • Distribution or business system are different (insurance) • Companies need to be responsive and agile (home appliances)

Author reproduction, Ghemawat 2001

The resources needed in order to support a well functioning capital market are provided by a range of institutions, and emerging market, hence Brazil have presented a range of institutional voids over the years. These voids vary from nature and extent throughout the different countries. There are three primary markets that drive the development of business strategy in any economy – product, labor and capital markets, and institutional voids can be found in any or all of these markets in developing countries. It is important to highlight that some industries are more institutional intensive than others; therefore, different industries within the same market are affected differently by institutional voids. (Khanna & Palepu.2008)

Once a company is entering an emerging market, institutional voids have a real and first order effects on business strategies. Looking at the capital and financial markets, per instance: financing options depend on capital markets intermediaries, such as commercial and investment banks. Raising external capital requires credibly convincing external capital providers that the money

being sought will be used in the way it was intended. Sometimes that could be highly difficult if there were no independent auditors and if there were no recourse mechanism available for investors in the face of after fact disputes.

These institutional voids can be presented in the form of absence of qualified human capital in emerging markets, lack of regulatory framework, support agencies such as rating agencies and auditors and so on so forth. All of these different aspects of a market are important, especially when you are dealing with capital markets that are human capital and institutions intensive. There it is important to address the presence or absence of institutional voids for matters of strategy and sustainability of competitive positioning. (Khanna & Palepu.2008)

3.8 Key Takeaways

In order to sum up all the literature contributions from the review, key takeaways are in order. Generally speaking the industry of private equity is quite new and there are still different definitions about this category of investment. In this review the characteristics of the industry in different areas of the globe were presented in order to provide tools to conduct the sectorial analysis that will be taken on in the following chapters.

Private equity, as previously mentioned, is a sector of the finance and investment industry that invest in or acquires a company's securities in a negotiated process with the intent to actively implement a value added management strategy to transform the company capital structure operation and management. This kind of strategic intervention can enhance companies' operational efficiency, organic growth, or even invest in merger & acquisition and in a professionalization of management.

The small and medium companies account for most of the activity in the business, and for that reason there is lack of available information about their activities and that requires methodological simplifications. In the Brazilian case most of the deals conducted are focused on family owned business once

a large category of companies in Brazil have this nature. This category has a more informal manner and therefore a lot of attention needs to be given to the due diligence and auditing processes.

A deal in private equity is generally expected to last from 5 to 7 years, and are subject to a range of risks. The risks in the private equity arena are subject to the cyclical nature of the business and also to the macroeconomic context of the market. In Brazil we have a macroeconomic scenario that is under improvement with the new regulations such as CVM, FIP and Novo Mercado but the landscape is yet far from the one you will encounter in advanced capital markets. The new legislation however, is perceived as welcoming to foreign investors.

In addition to that, culture also plays an important role in the market. One can perceive the differences between the entrepreneurial American society and the conservative European investors. In Brazil there is a more risk prone society, however the legal framework and uncertainties end up molding the sector. Currently, there has been a lot of capital available in the market with ends up raising the prices of big-ticket deals in the major cities such as São Paulo, Rio de Janeiro and Belo Horizonte.

The legal paramount of the Brazilian market also shapes the nature of agreements being held, whereas you have the different sides to the shareholders agreement. In one side you can enter in an investment as a minority shareholders and be more vulnerable once you don't have a set of law that fully protects you, either you will have to pay the premium price to be the controlling part of the deal. In cases of disputes normally when drafting the shareholder agreements parts indicate arbitration as the tool for resolution since the Brazilian judicial system doesn't function as rapidly as the industry moves.

Another caveat that needs to be taken into consideration is the availability and well functioning of institutions. The pool of financial analysts, rating agencies

and also the medias source of unbiased information and also how effective are the country's banks, insurance companies and mutual funds in collecting savings and channeling them into investments? Moreover, are the financial institutions managed well? And is the decision process transparent? And can companies raise large amount of equity capital in the financial market?

Governance is also important for businesses and the relationship between investors and investee. How effective are the governance laws? The Novo Mercado Rules have been created to tackle this feature of business and companies both listed and unlisted are gradually adopting to this practice. Additionally, the effectiveness of boards and how the private equity investor relates with it is also an inquiry that is conducted.

As far as exit of the investment is concerned the development of the Brazilian capital market has created an opportunity to use Initial Public Offering as an exit strategy. In the last couple of years we have observed the flourish of Bovespa in the market and that establishes a new exit alternative from Private Equity Funds from their investments.

The availability of talent is something critical when dealing with capital market and that should be taken into consideration when analyzing capital markets in general. The Funds need talent to incorporate in their businesses and also talented managers that they can use to manage or support the management and apply the strategic improvement in the investees. This is an important matter for the industry in general.

Moreover, it is important to take into consideration that the Brazilian market, being an emerging market has a series of institutional voids that the strategy of private equity funds must contemplate, and the distance between headquarters and subsidiaries can create a range of barriers from business and those barriers need to be surpassed so that foreign private equity funds can flourish in the Brazilian economy and help the country grow as the industry did for the United States and Europe years ago.

4. Presentation of Findings

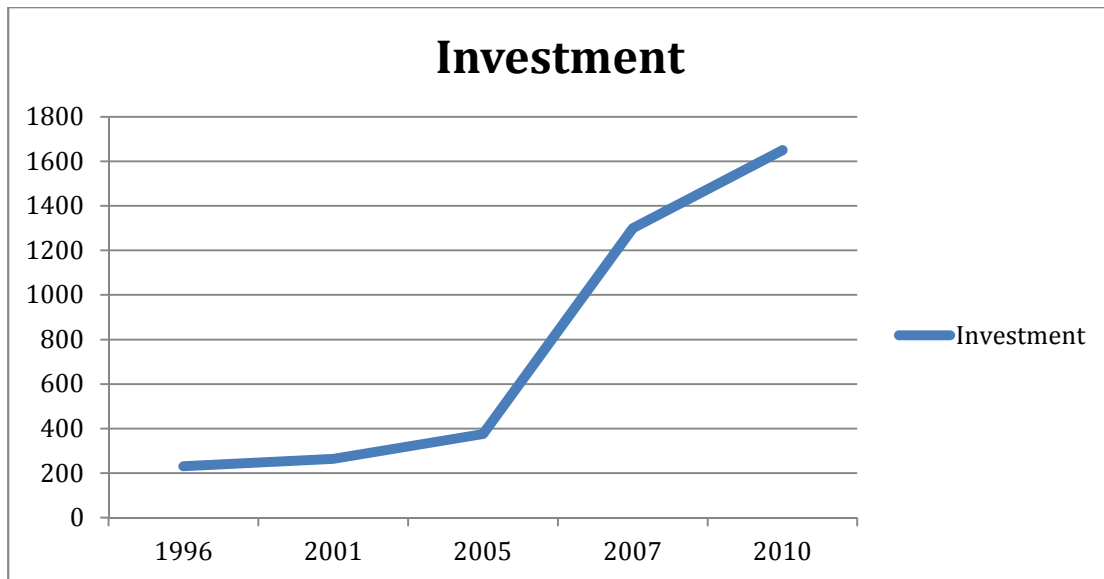
The general objective of this research as expressed above is to point out the main challenges in terms of strategies that private equity funds are facing in the Brazilian market. In order to perceive how the sector is developing in Brazil primarily, how foreign funds are dealing with the market a few interviews were conducted. The three Funds respondents in this research where: Advent International, The Carlyle Group and Mercapital.

4.1 Companies

4.1.1 Advent International

Advent International was established in 1984, and has a cumulated total of more than 37 billions of dollars in invested capital. Advent has a global platform of investment that has more than 160 investment professionals, and over 70 operating partners. The fund has three global regions of investment: Europe & North America, Latin American and Eastern Europe, which have respectively 10,8 billion US\$, 1,65 billion US\$ and 1,6 billion US\$ dollars invested.

Even though Advent has settled a 1,65 billion US\$ exclusively to the region, it can also assess part of its global fund (10.8 billion US) to invest in Latin America. The fund has already invested in more than 40 Latin American companies with a market value of over 10 billion dollars, and also has raised, more than 5 billion dollars exclusively for the region. In the graph depicted below one can visualize the upward direction investments have taken in Latin America.



*Values in Millions of dollars

In the Latin American continent Advent has offices in Brazil (São Paulo), Colombia (Bogotá), and Mexico (Mexico City). In the São Paulo Office, there are 11 investment professionals, and the interview conducted was with Brenno Raiko, which is a Senior Associate. In order to have an idea of how the company invests in Brazil it is important to highlight a few of the recent deals Advent has entered. The company has made investments in different sectors, and has chosen to open the company's capital on several occasions. The company has engaged into IPO more than 145 times around the globe, and in 7 occasions in Brazil.

Company	Segment	Exit
TCP Terminal de Containers	Logistics	-
Kroton	Services/Education	IPO ⁵ Bovespa
IMC	Food and beverages and concessions	IPO Bovespa
Quero - Quero	Retail/ Financial Services	-
Atmosfera	Outsourcing services	-
Dufry South America	Retail/ consumer goods	IPO Bovespa
Cetip	Financial services	IPO Bovespa
Paraná Banco	Bank/ Insurance	IPO Bovespa
CSU Card Systems	Outsourcing services	IPO Bovespa
Microsiga/ Totvs	IT	IPO Bovespa
Atrium	Telecom	Sold to Telefonica
Asta Médica	Pharmaceuticals	Sold to Aché

In most of the investments Advent takes into its portfolio the revenues are generated through corporate growth, represented through its EBITDA. The figure the enterprise presented are 82% of growth through EBITDA in its investees. There are 5 main drivers for this success that are: expansion through mergers and acquisitions, international expansion, organic accelerated growth, operational improvement and capital markets access and relationships.

⁵ Initial public Offering

4.1.2 The Carlyle Group

The Carlyle Group was founded in 1987 in Washington DC, United States. It has more than 170 billion dollars under asset management across 113 funds. It has more than 1400 professionals working in their offices across different regions of the globe: North America, South America, Europe, the Middle East so and so forth. Carlyle's team is formed of more than 650 investment professionals around 33 offices within 21 different countries. In Latin America it has offices in Lima, Peru and São Paulo, Brazil. In the São Paulo office the team has 14 professionals and Amaury Takaki, Associate described how the business has been developing in Brazil.

The Carlyle Group focuses on being the controller investor in its portfolio companies, however it generally keeps funder partners within the company. The Carlyle Group first got into Brazil with foreign teams that were dealing with a global fund. Nowadays the company counts with local teams that deals with a fund directed specifically to Latin America, which includes funding that was captured locally. The Carlyle office of São Paulo was established in 2007 and started a new wave of investments in the country that includes companies such as Tok Stock, Rihappy, Alcalina and so forth. The local fund accounts of 1 billion dollars, and the São Paulo Office has a team of 14 investment professionals.

4.1.3 Mercapital

Mercapital is an European fund based in Spain, it has more than 25 years old in which it has invested in more than 115 companies and 64 platforms. Currently it has more than 1.4 million euros under management, 34 investment professionals and offices in Madrid, São Paulo and Miami. It is specialized in middle market and has developed projects in a range of industries. The main strategic objective of Mercapital is to support Spanish and Portuguese companies that are expanding to Latin America.

He started explaining that Mercapital is a Spanish investment firm that was created specifically with the mandate to invest in companies of the Iberian Peninsula Region. It was first established 25 years ago and have dealt with 9

closed cycles of investment so far. As far as the historical track record of the Fund is concerned, he says that it has gone through different macroeconomic scenarios, and that what is observed today in Brazil with family companies and revenues based in organic growth was the scenario in Spain around the inception of the company.

4.2 Description of interviews

4.2.1 Advent International

In the course of Brenno Raiko's interview he has mentioned several important characteristics of the Brazilian market that are going to be depicted below. The main question was for him to describe what he perceives as challenges in the Brazilian market, as well as differences, when comparing it to foreign mature markets such as the United States, home country of Advent.

In order to better structure the information the conversation was divided into the different stages of Private Equity deal. He mentioned that in the United States companies normally seek out for funding in banks and since its inception companies are already being structured to the stage in which they will need funding; either through the lending from banks or the inversion of capital by Private Equity Funds. He stresses out that American companies don't question if they are going to need funding, but already start planning when they will need this kind of support. American companies have a clear distinction of the positioning and strategic value of a shareholder, and they have a clear separation of owner, founders and shareholders therefore having a clear perspective of their different roles within the organization.

On the other hand, when looking at Brazil the situation is quite diverse. Raiko mentions that Brazilian companies don't plan their activities and financials for the moment when they are going to need funding, and also they have a very blur distinction between owner and shareholders; which makes company structure so much more complex and difficult to assess when engaging in a

due diligence, per instance. In the Brazilian case, owners and CEO's have generally not thought about funding until the very moment when they need it.

Additionally, the Brazilian market has another challenging caveat presented in the form of taxes, which according to Raiko are a "nightmare". There are many fiscal and labor contingencies that need to be taken into consideration when analyzing a prospective investment. There is complex legislation that have recently been changed and those changes will abruptly affect small and medium companies. And when it comes to auditing it also really difficult to find the right institution to perform the job.

There has been the first boom of private equity in Brazil in the 90's and Raiko points out that from that period Advent is the only international fund that was physically present in the Brazilian market all times, whereas the other international funds either used fly-in investors, or were absent in the Brazilian market during a period where the macroeconomic situation of Brazil wasn't as bright as it is nowadays. The reason why Advent was capable of maintaining its team in Brazil, is the fact that they were the only one's with a fund directed specially to Latin America at that time.

Regarding the physical presence in Brazil, Brenno was asked if there is a necessity of being physically in the Brazilian market in order to effectively operates around here, and he mentioned that it is indeed possible but makes things generally more complicated to be located somewhere else. He said that the screening for deal is something you can do from abroad, however it is really hard to operate a due diligence from abroad once Brazilian laws and requirements of the market are not black and white and usually will need to be interpreted by a local expert.

Coming about the process of due diligence, after screening and facing a possible opportunity the investor will find a great deal of uncertainty that can be from different areas such as fiscal, labor and the troubled role definition between shareholder and owner. There is great confusion, especially in family owned companies between *pessoa física and pessoa jurídica*. A range of

those CEO's per instance don't receive salaries but yet big sums of dividends which makes the understanding of the financials of the companies more complex.

A Private Equity fund, according with Raiko, can come across a possible deal in Brazil either through a Bank, or a referral from the market. In most cases the executive looking for funding for its company will be referred to Advent and also the other way around. Therefore, with no planned funding structure the due diligence process will be extensive and more expensive than it would be in mature markets. Generally a Private Equity Fund will have the necessity to hire layers, consultants and auditors. The due diligence process in Brazil, says Brenno, takes an estimate 6 to 7 months to be completed, on the other hand, in the United States the same process would take around 1 and a half to 2 months. These will incur more costs and more dedication to one's project.

In addition to that, Brenno also mentions that the talent pool in Brazil is more limited than one's in mature capital markets, mainly when it comes to the professional with the combination of experience, seniority and specialization. In a second level, there is also a limited varied of professionals, however, you can more easily access professionals arising from base industries than ones with a high level of seniority.

When it comes the time to exit an investment, there is the rise of Initial Public Offering, which as Brenno explained is something cyclical in Brazil. There are waves of IPO during a period of time, after the market remains low for sometime and then again you will have a new IPO wave. However, there is always an exit option in Brazil that is to sell to strategy, as it happened per instance with Atrium that was sold to Telefonica. Brazil is a trendy way to go right now, so we see a range of opportunities.

When it comes to sectorial focus in Brazil, Brenno explains that the sectors that are in vogue currently are the ones less capital intensive, such as, retail, services and consumer goods. As an example he mentioned Kroton, which is in the education segment and has received investment from Advent.

In regards to the process of due diligence still, Brenno says that normally there are deep reference checks and the investment period is around four to five years. Moreover, the new regulation that was established with FIP and CVM made the rules of the market more clear and represent a regulatory landmark. However, there is no general voluntary adhesion to the New Market rules of Bovespa. Public companies will follow its guideline, however private companies will only go as far as creating an administrative board.

There are funds in Brazil that will engage into minority shareholders activities, however, Advent international only acts as the majority shareholders and controlling group. It is a really hands on fund that likes to work closely with the management of the investee. Brenno stresses out that it doesn't mean that it will replace management; on the contrary it will provide the necessary tools so management can flourish. Advent stays really close to the board of directors, it places 2 financial executives close to management, has a monthly counsel meeting, as well as specific committees that are focused on specific areas of the company.

As far as competition is concerned, it has grown throughout the globe, but it is focused on big ticket deals that in the case of Brazil will have local players as well as fly in contestants. The processes that will involve a big-ticket deal structure by a bank will have a more competition and therefore an overvaluation of prices. However, in the case of Advent most its business come from referrals of the market therefore its not an environment as competitive as generally it would be. As an example, currently the company is acting in three proprietary deals.

In regards to revenues, in Brazil they come from the growth of the company rather than financial leveraging. There have been no disputes settlement in the case of Advent even though the indication to use arbitration is in all their shareholder agreements, but Brenno says that as the period of investment is short and a lot is at stake any disputes went that fare, but if they eventually do they will be dealt with in the Canadian- Brazilian chamber of commerce.

4.2.2 The Carlyle Group

In The Carlyle Group, Amaury Takiki Associate of the Brazilian office explained how the Fund operates, and how it deals with the Brazilian coefficient. In the 90's Carlyle would only act as a fly-in fund and would bring foreign professionals to foster investment opportunities in the Brazilian market. As soon as they started working on projects in Brazil they've realized the Brazilian tax stability and how the dynamics of the sector were really different of the North American markets.

In their attempts of conquering the Brazilian market the business model of starting a local branch with a local team turn out to be the best option. Amaury highlights that in the past Brazilian funds have had an equal or superior performance compared to foreign funds. Takaki mentions that the Brazilian economy is quite peculiar compared to the rest of the world, there have been historical inflation, our capital markets are rather limited and the Brazilians don't have developed the "investment" culture. When one looked at the financing alternatives they were few in Brazil, and leveraged buy out is something quite new to the region and is starting to develop nowadays.

He mentioned that the fund is quite acclimatized with the Brazilian scenario since it does business all around the globe, and has create the capabilities to operate internationally. However, one of the greatest issues in this market is to deal with the informality that is a strong characteristic of national businesses. This informality is present in the organization, control and management of prospective investees, something that will affect revenues, per instance, since the information given by the company is not always clear or sharp.

Generally, in the Brazilian market the investor will find a wide pool of family business to invest, which are not usually audited. Governance is never a simple matter when it comes to family business. The Carlyle group acts both

as majority shareholder, and in some specific cases minority shareholders. Amaury points out that the shareholder agreement is always a delicate and important milestone in the investment process, and that in the case of Brazil this gets even more complicated due to the legal confusion one may find in the country since regulations are not always “black and white”.

When it comes to the relationship of control with the investee in both case as the controlling shareholder or being the minority one, Takaki stress out the politics and in smaller or larger degree is always present. The Carlyle Group does not always replaces management when it is the controlling shareholder, but they use a case by case approach in order to evaluate when replacement of management is needed.

The due diligence process also came up during the interview and that is something that requires the Fund to hire a range of professionals such as auditors, lawyers and professional consultants. He mentioned that compliance with legal requirements is something that demands a lot of work since legal guidelines are in constant transformation in Brazil and the specialized professionals not always have a complete understanding of it. Therefore, the fund must follow those processes from up close.

As far as sourcing is concerned, The Carlyle has three main sources of business: boutiques and Investment banks, networking and proprietary contact that normally occur through cold calls. He states that generally the first form of sourcing is used in a larger degree however; business development comes from all three fronts.

Another caveat of the market that is important to understand is the find the right talent Takaki mentions that it is indeed of the greatest challenges in the market. The first step to find specialist in the sector that the Fund aims to invest is to look through their network, and as a second possibility hire firms specialized in executive search to screen the market in order to find the talent they are in need. “Find management nowadays is a big challenge”.

In addition to that, Amaury mentioned that the market is under a general maturation, something that occurred in the United States quite a while ago. The Brazilian government has been really interventionist in the last couple of years, and it turns out that ends up affecting negatively private investment, some analysts suggest that the amount of ruling will grow further and this unpredictability is also a risk factor when looking at the market.

Another risk associated with doing business in Brazil, as he mentioned, is the fiscal contingencies firms might have and that would appear during the due diligence process. This phenomenon occurs due to the high traits of informality in the Brazilian market that reaches all sectors of businesses and is quite evident when dealing with family owned companies. Even the professionals that are involved with these services such as accountants and lawyers have difficulty dealing with the fiscal activity of companies.

As far as exit of investment is concerned, in Brazil The Carlyle Group has made an exit of only one of its investments through an IPO, which was the Qualicorp case. There are always other options of exit in the Brazilian market such as the sale for strategic, business recap⁶, or even the sale of the investee to another fund. Generally speaking the growth of investees will be the result of a growth in the market share, an enlargement of its margins and M&A. Moreover, Takiki estimates that revenues based in organic growth are supposed to represent less and less of the overall investment success due to the macroeconomic scenario, however with the lowering of interest rates he sees leveraging as being a growing appealing alternative and also operational improvements.

4.2.3 Mercapital

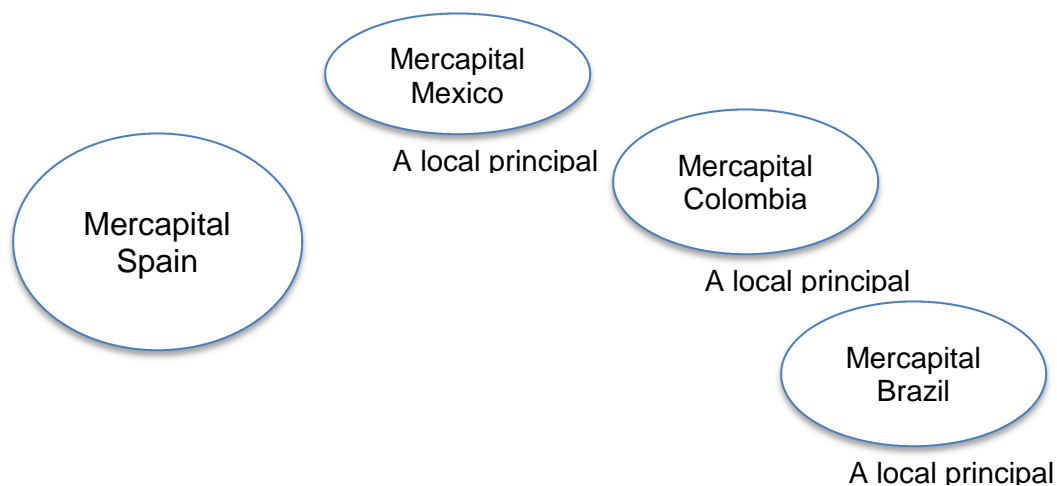
The last interview conducted was with the principal of Mercapital in Brazil Fernando Almeida Prado. Fernando says, that in Europe the market has matured and entered into the leverage arena, and a few years ago debt was a

⁶ When a fund has enough in the cashier to pay off its initial investment.

big part of the business. However, with the sub-prime crisis in the United States that also affect capital markets in Europe, Mercapital had to let go of using debt and started operating only with equity. Ultimately, as an effect it didn't had a range as big as before to invest in potential deals.

A few years ago, around 2009 Mercapital decided it had to change its business in order to be kept in the game, therefore, it decide to amend it mandate in order to include Latin American investments in its portfolio. Since the fund has only one fund raised globally it had to make sure the investors were on board with the new direction the business was taken. Finally, they came up with the solution of investing in Spanish and Portuguese business that had already a footprint in Latin America or were interested in doing so.

The Mercapital investment process works as follows:



Screening	Due-diligence	Investment	Monitoring
<ul style="list-style-type: none"> • Europe • Local 	<ul style="list-style-type: none"> • Local 	<ul style="list-style-type: none"> • Europe • 	<ul style="list-style-type: none"> • Europe • Local

The graph above attempts to illustrate the fact that even though the investments are done in Latin America they are focused on Spanish and Portuguese companies that are expanding to this market. That as mentioned above is due to the mandate of the fund and its adaptation to include Latin American investments. In that sense, there are two types of projects Mercapital searches for: Portuguese and Spanish companies that are interested in merger and acquisition, as well, one with expansion projects that would need further funding.

The capital is allocated in the headquarters of these investees based in Europe, whereas the daily business is conducted by the subsidiaries. In the case of Mercapital Brazil they have per instance worked with the expansion of the Rubaya restaurants both to Brazil, as well as, to Latin America. They selected the Restaurant in Madrid as the headquarters and as the gate for investment.

Fernando mentions that Mercapital is in a transition phase trying to get to know the Brazilian scenario and preparing itself to raise funding locally in the upcoming years. Mercapital is specialized in the Middle Market and normally invest in family businesses, which is a frequent process in Brazil. The family companies in Brazil normally will look for a Private Equity investor when they are not interested in leading the business anymore. Fernando mentioned that in several cases they look for a Private Equity Investor because the founder of the company per instance cannot work anymore and heirs are not interested.

In the Brazilian market, due to the fact that Mercapital is relatively a new entrant they still have to depend a lot in institutions such as assessors, M&A Boutiques and Investment Banks. These intermediaries are going to support the screening process in order to find Mercapital investment opportunities that will be within the companies mandate. As far as screening and attraction of new business is concerned referral is also used in the market but the company needs to develop a strong brand in order to attract investees.

Moreover, competition is another topic discussed during the interview. Fernando mentions that the middle market is not as competitive as the market for big-ticket deals, and Mercapital has always conquered exclusivity to analyze its possible investments. However, the challenging part to deal with the Middle Market is to deal with companies that are not well structured and focus a lot in the due diligence process.

The due diligence process in its essence is supposed to be conducted simultaneously in all different arenas. However, Fernando mentions that in Brazil due to the lack of structure and governance in the businesses, they conduct the financial due diligence first in order to make sure the numbers are accurate, which aren't most of the times. This helps funds to avoid spending a range of resources conducting the full due diligence process for each opportunity.

Companies in Brazil are generally not audited and there is a strong lack of governance, he mentioned. However Mercapital has a good learning since that was the scenario of Spain in the past. The General Partner in a Private Equity Fund has to go under a deep analysis of the risks and the way you structure your shareholder agreement is extremely important. In the case of Mercapital with generally enter the agreements being a minority shareholders this importance grows even bigger. As a minority shareholder you are more vulnerable in the agreement, says Fernando, and being a majority shareholder you will definitely have more control of the business and more power if you end up having to solve legal disputes.

Fernando says the value of the company is in its management team, so if they enter an investment as the majority shareholder they will try to make sure the best person is running the business, and this analysis is done case by case. However, they are always going to have an important actor within the company, even when they enter agreements as minority shareholder. The most common practice is for them to appoint a financial executive to join the company, such as the CFO.

Another topic discussed during the interview was the new regulations and directives of capital markets in Brazil and how they are affecting the industry in general. Fernando says that in theory things work perfectly, however in daily business they are not as used as they are intended to. However, the new regulatory framework brought more transparency and security to the industry. In this case FIP was important.

The fiscal arena in Brazil is far too complicated for international investor that finds it complex and difficult to understand. In the due diligence process the biggest contingencies are fiscal and labor. There is a lot of confusion when it comes to the “*pessoa juridical and pessoa física*” definition, and a range of legal complications when you don’t address the matter properly. Therefore when conducting a due diligence these issues play a central part of the analysis.

In the talent arena the strategy of the fund is to hire a local principal in each market a subsidiary is established. This practice brings to the fund access to the local culture while keeping the Spanish executives active in all the different markets. In general it is harder to find the right people in Brazil to specific position and Fernando says PE funds have to be creative. He mentioned that he himself had not prior experience in the Private Equity arena before; however had the general industry expertise that ultimately gave him the job he performs currently. “ I was an company expert and therefore I was hired”

5. Analysis and Interpretation of the Findings

The results of the interviews conducted were very interesting and some will correspond with what is depicted in the previous literature, while others will point out another direction. In order to better segment the different conclusions this chapter is going to be divided into different parts that correspond to the different stages of the Private Equity relationship with investees and presence in the local market. Even though the funds interviewed have different sizes and act in different scopes in Brazil, they all have the international investor perspective and have dealt with advanced capital markets before.

Two American parts, Advent International and The Carlyle Group, represented the sample of funds and the third fund was European, more specifically Spain and was represented by Mercapital. It is interesting for the sake of this research to compare their business models and sizes because eventually within the analysis it is perceivable that despite their difference in sizes, focus and strategies they have all a common vision about the Brazilian private equity industry.

Advent international	The Carlyle Group	Mercapital
<ul style="list-style-type: none"> • Entered Brazil in the 90's • Latin American Fund • Big-ticket Segment • Majoritarian shareholder • Sourcing through referral and proprietary contact • 11 Employees in São Paulo • Local Team 	<ul style="list-style-type: none"> • Entered Brazil in 2007 • Global Fund • Big ticket segment • Majoritarian/ Minority shareholder • Deal through investment banks and proprietary contact • 14 Employees in São Paulo • Local Team 	<ul style="list-style-type: none"> • Entered Brazil in 2009 • European Fund • Middle Market • Minority shareholder • Deal Through investment banks • Hybrid team

5.1 Sourcing of Business Opportunities

The screening of business opportunities was one of the topics addressed in the interviews conducted. The respondents all suggested that this is not a critical reason for the Funds to establish a subsidiary in Brazil whereas the screening is the only part of the process that can be made through fly-in investors. It is clear that the means funds used to access the market varied according to their size and maturity in Brazil. Advent International attracts business opportunities both actively and passively and in most cases the prospect client goes after the Fund through a referral in the market. Networking and a good track record is fundamental for a company to have such access to the market.

The Carlyle Group, adversely, still uses investment banks and boutiques to screen for businesses, however it has also dealt with referral and cold calls from prospective investees. On the other hand, Mercapital only works with Investment Banks and Boutiques as a source for new business mainly because of the novelty component of their Brazilian branch, as well as, the focus they have in a specific type of deal.

In the literature, competition was brought up, mentioning that more and more with the injection of capital in the Brazilian market the valuation of deals are rising in prices. This applies specifically to big-ticket deals that are managed through banks and other intermediary institutions. Advent mentioned that this doesn't happen with them because of the nature of their sourcing, and Mercapital deals with middle market however it has never entered into an action process in the Brazilian market.

5.2 Due diligence Contingencies

All the interviewees strongly emphasized that the due diligence process is critical in the Brazilian market for a range of reasons, most of the reasons are around the fact that in Brazil there is a lot of informality and rules and guidelines are not completely clear and have changed over the years. Generally in the advanced markets the process of due diligence is conducted during 1 and a half to two months and all fronts of due diligence are carried on in the same time. In Brazil, nevertheless, Funds tend to conduct the financial due diligence first in order to assess the accuracy of the number presented by the prospective investee.

In the Brazilian scenario due diligences will normally take up to seven months according to Brenno Raiko from Advent. That makes the process more costly and it requires more management and specialist dedication to each analysis. All the interviewees mentioned that the Brazilian fiscal and labor arenas are really important when analyzing a prospective investment. This is the case because the regulations around these two areas are complex and demand attention. And also companies abide them as strictly as necessary.

There is a general issue when dealing with Brazilian companies that consists of lack of governance and informality. There is a confusion between *peessoa física* and *peessoa jurídica* which occurs quite frequently in Brazil in order to reduce the taxes due, and that more frequent than not is present in the companies target for private equity. This lack of governance and informality also relates to the fact that most of the targeted companies for investment in the Brazilian economy are family owned businesses.

5.3 Structure of Investees

The structures in which the investees are developed are also a determining factor within the development of private equity investments locally. Brenno Raiko, for Advent International, as well as the other interviews had a similar perspective around this matter. Brenno says that in the United States, per instance, since the establishment of a new business venture companies are already structure for the moment in which they will need funding, that would be just a matter of time. On the other hand, Brazilian companies are created

without any structure for funding and when it comes the time to go on the market for capital they do not have the same “organization” as one would find in the United States.

Therefore, Brazilian prospective investees require an extensive analysis of their businesses before Private Equity Funds decide to invest in them. Companies are generally not audited and Funds will require a series of intuitions to support their analysis of the business. Auditors, lawyers and professional consultancies are normally used by Private Equity Funds accessing prospective opportunities. Alternatively, when companies are backed up by investment banks trying to find investors they may be more organized and with the possibility of an easier evaluation.

It is important to take into consideration that culture plays a determining role in this case. In the United States you have the entrepreneurial spirit of the business community, whereas in Brazil most of the businesses are family owned developed around an idea but not necessarily with the professional management needed. That is when private equity investors come in to create value to the business and develop strategies so the company can grow and the investment is successful.

5.4 Strategic relationship with the investee

In the Brazilian case, according to the interviewees, the relationship with the investees is quite close. The three interviewed funds related that they are really hands on and integrated to the businesses they invest. The ones that are majoritarian shareholders or controller normally affect the business more intensively. However, they not always replace management. The Carlyle Group, states that they use a case-by-case approach, and Advent International mentions that they use different committees in order to support distinct areas of business that are in need of support. Mercapital, which acts as a minority shareholder most of the times normally, appoints one executive to the company, which generally is the Chief Financial Officer.

One of the main characteristics of a Brazilian private equity fund is that it participates in the decision making process of the relevant company, notably through the appointment of members in the board of directors. (Flesch & Silva Prado, 2008)

5.4 Access to talent

The talent pool is something you have to access in order to develop markets, especially when you are addressing capital markets that are talent intensive. In the case of the Brazilian markets it is clear by the response of the interviewees that there is a lack of available talent, however it is important to hire local managers because of the cultural particularities of the country. Therefore, funds need to be creative in order to find the right talents for their investees and even for their own team.

Brenno Raiko, from Advent International, mentions that there is a range of talent in the base industries since they are traditional in Brazil; however when you search from executives per instance in the media sector the pool of talent is not as wide. It is difficult to find the combination of seniority, expertise and specialty. One can find, per instance, a senior executive of the mining or metal sector, however it is hard to find someone that has worked several years in the media sector and is specialized in twitter. This phenomenon affects the leadership of the companies that will have to compromise in one of the categories. Normally executives with lower level of seniority compose management that is different than it would be in mature advanced markets.

Fernando Prado, of Mercapital, is a clear example of that. He is an experienced professional in the corporation segment and has worked in different areas of several big companies. He is currently the Principal of Mercapital in Brazil, but it is the first time he works in the industry of Private Equity. His choice for the position was due to the management creativity and flexibility when accessing the Brazilian pool of talent. They accessed what were the main features of the candidate and which ones were of second importance.

5.5 Regulation

It is of general assumption that the legal paramount is substantial for the development of a market. The economy has been developing in a sustainable upward trajectory; due to the market-friendly policies that have been adopted during the past few years and that affect the capital markets and the Private Equity sector positively. The FIP, CVM and Novo Mercado were new steps towards a better and more transparent market and that has been noticed by the Private Equity Funds.

The Carlyle Group represented by Amaury Takaki, mentioned that the Brazilian Government has been quite interventionist in the last couple of years. The success of the *Novo Mercado* and general increase in the Governance standards depth and transparency in Brazilian capital markets provide private equity funds an invaluable exit platform for their portfolio company investments. Overall the new developments in this arena are truly a regulatory landmark, as mentioned Brenno Raiko from Advent International.

5.6 Exiting an investment

Once the funds have reached its objectives, they will start to look for manners to liquidate the investment. The interviewees had similar views about this process in Brazil. It is a fact that the IPO era brought a different alternative for exit investments in Brazil. However, when looking at scenario that contains mostly family business that alternative is not used quite frequently due to the size of the enterprises and the macroeconomic scenario in Brazil. Nonetheless, exits via IPO have already happened in the Brazilian Bovespa and this kind exit is becoming more frequent in Brazil, however, it happens in waves of a couple years at a time.

The general and most common manner to exit an investment in the Brazilian market is to sell the investment to a strategy. That happens most of the times, also, there is the possibility to sell stake in a fund to another fund but that practice is not yet widespread in Brazil perhaps because of the size of the

market. In addition that, the Brazilian government has created the Bovespa + with the intent to foster smaller IPO's for companies that want to be publicly traded, unfortunately the practice has not been used in great proportions.

As far as revenues is concerned, funds have had the opportunity to watch their investees grow trough accelerated organic growth is most of the cases. Merges and acquisitions are also a partly responsive for the success of investments, as well as, operational improvements. These phenomenon is correlated to the growth Brazilian economy has had in the last few years. The future however, looks a bit different and with the interest rates dropping Amaury Takaki from The Carlyle Group, sees more and more the growth of leveraged capital in the Brazilian Private Equity Industry.

5.7 CAGE Analysis

In order to analyze the effects of the four dimensions of distance in the Brazilian private equity sector, the framework presented before is presented one more time, with the key variables highlighted. As highlighted in the framework below the financial services are affect more by some aspects of distance than others. In the case of the Brazilian private equity sector all four dimension have, in a bigger or smaller degree, some effects on the daily activities of businesses.

	Cultural Distance	Administrative	Geographic	Economic
Attributes creating distance	<ul style="list-style-type: none"> • <u>Different languages</u> • Different ethnicities; lack of connective ethnic or social networks • Different religions • <u>Different social norms</u> 	<ul style="list-style-type: none"> • Absence of colonial ties • <u>Absence of shared monetary or political association</u> • Political hostility • <u>Government Policies</u> • <u>Institutional Weaknesses</u> 	<ul style="list-style-type: none"> • <u>Physical Remoteness</u> • <u>Lack of a common boarder</u> • <u>Lack of sea or river access</u> • <u>Size of Country</u> • Weak transportation or communication links • Differences in climates 	<ul style="list-style-type: none"> • <u>Differences in consumer incomes</u> • <u>Differences in costs and quality of:</u> • <u>Natural resources</u> • <u>Financial Resources</u> • <u>Human Resources</u> • <u>Infrastructure</u> • <u>Intermediate inputs</u> • <u>Information or Knowledge</u>
Industries or products affected	<ul style="list-style-type: none"> • Products with high linguistic content (TV) • Products affect cultural or national identity of consumers (food) • Product features vary in terms of: <ul style="list-style-type: none"> • Size (cars) • Standards (Electrical Appliances) • Packaging • Products carrying country specific quality associations (wine) 	<ul style="list-style-type: none"> • Government involvement is high in industries that are: <ul style="list-style-type: none"> • Producers of staple goods (electricity) • Large employers (farming) • Large suppliers to the government (Mass Transportation) • National Champions (aerospace) • Vital to national security (telecommunications) • Exploiter of natural resources (oil, mining) • Subject to high sunk costs (infrastructure) 	<ul style="list-style-type: none"> • Products have a low value-to-weight or bulk ratio (cement) • Products that are fragile or perishable (glass, fruit) • <u>Communications and connectivity are important (financial services)</u> • <u>Local supervision and operational requirements are high (many services)</u> 	<ul style="list-style-type: none"> • Nature of demand varies with income level (cars) • Economies of standardization or scale are important (mobile phones) • Labor and other factor cost differences are salient (garments) • <u>Distribution or business systems are different</u> (insurance) • Companies need to be responsive and agile (home appliances)

Author reproduction, Ghemawat 2001

The first aspect of distance is the cultural one; it will address how people interact with each other and also companies and institutions. Two aspects that contribute to this difference is the different languages between headquarters and local subsidiaries' and also different social norms. In Brazil, more precisely, in the private equity sector companies will perceive this difference due to the high level of informality observed locally. As interviewees commented the informality of businesses and relation presents a big challenge and foreign funds need to adapt their business to this new reality.

Secondly, the administrative distance also plays a significant role in the private equity sector locally. Mainly because the government is the one fixing taxes and regulating the financial industry, the new FIP rules and all the developments towards a more transparent financial market has enable the presence and development of more and more international private equity funds locally. Interviewees mentioned that the Brazilian sector is flourishing;

nevertheless, it is not yet possible to lean on all the characteristics presented in advanced markets, per instance the high volume of IPO's, because of the size of the industry and characteristics of deals that generally involve family owned businesses.

Moreover, the geographic distance is expected have an effect on the financial industry between countries, once the authors indicate that information structure is highly important for the development of this type of industry. It was detected in the interviews that this is in fact an important characteristic, however, Brazil has evolved a great deal in the matter and nowadays there is a range of international banking institutions in the local market, and the geographic distance is no longer a great challenge.

Finally, the most important distance arena is the economic one. It still plays a big role in the Private Equity sector in Brazil due to a range of facts. Generally speaking the economic distance regards the costs and quality of financial resources, human resources, general infrastructure so on and so forth. Looking at the Brazilian side through the perspective of the interviewed funds, it is important to highlight that there is a lack of specialized human capital, financial resources are becoming more and more refined with time and infrastructure is not yet as in their home markets; and needs attention.

5.8 The effects of Institutional Voids

As mentioned by the authors Khanna & Palepu, Institutional voids have real order effect on business strategies when entering in a new market. In the Brazilian sector of private equity the capital market intermediaries play an important role as being part of an institutional void, or institutional underdevelopment. The greatest characteristic of the Brazilian market of private equity is that the industry does not rely on leveraging for growth, but relies on other sources of development such operational improvements, accelerated organic growth, internationalizing, M&A, and so forth.

Hence, if one takes a look at the international private equity sector leveraging has been a great part of the business. In order to be successful in Brazil, and mainly due to the early stage of development of national capital markets, International Funds such as Advent and Carlyle had to create different strategies to surpass the institutional voids presented. The challenge of operating differently had to be overcome, so the industry could flourish locally.

Another effect of this void was the challenge of raising capital locally, therefore, Funds would invest in Brazil with capital raised elsewhere mainly in Europe and the United States. However, with the development of the capital markets and the general stability of the local economy both the raising of capital and the option of leveraging are becoming more and more present in the reality of international funds with a local branch.

6. Conclusion and Recommendation

The private equity industry in Brazil is not as mature and developed as the one in Europe and the United States. However, it presents a package of characteristics that have been attracting foreign investors over the past years. Nowadays we observe a range of Foreign Funds actively operating in the Brazilian market. Advent International, The Carlyle Group and Mercapital are a small sample of the market looks like and how the international investor perceives challenges and opportunities in this country.

As a research objective in the beginning of this research three questions were proposed, the first referred about what international funds have learned in the Brazilian market, followed by how was the learning process developed and if there are still major gaps to be filled in terms of managerial strategy or practices. Throughout the analysis the perspective given to the issues presented were of the Private Equity Fund and that is also taken into consideration when concluding the takeaways of the project.

In terms of what were the learning funds have had in the Brazilian market, the main lesson was that in Brazil companies are still deeply informal and they don't have yet the structure for funding one will find in developed capital markets. This initial point reflects in all the process of private equity forward. Companies are not structure, and therefore also not audited so when the private equity investor comes in he will find a scenario with a great deal of confusion about roles in the organization, financials and legal aspects. In this first contact with the company the Private Equity Fund may decide to invest in a due diligence or not.

The due diligence process in Brazil is quite long and requires a great deal of resources and support of institutions; hence for this point onwards it is important for international private equity funds to establish a local branch and also local executives on the task. The reason why that is so important is that despite the new legal framework Brazil is developing, regulation is still blur

and the range of fiscal and labor contingencies possibilities in a Business are large due to the fact that informality is present in the market and companies are not always completely in order with their legal obligations.

Moreover, when dealing with the investees managers have learned that in the Brazilian market Private Equity Intervention means hands on management, however it doesn't mean a complete replacement of the managerial team but a strong support inside the investee so the company can develop all its potential. Funds will place experienced executives generally in the financial area so they can boost revenues in the investees, either by organic accelerated growth, enhancement of market share, operational improvements M&A or even leveraging.

Another caveat of the Brazilian market Foreign Funds have learned is that due to the tax burden of Brazil or, if you wish, Brazilian cost, leveraging has not been a very used alternative from growth or developing. Interviewees expected this to change in the upcoming years with the lowering of interests rates and the deceleration of growth in the overall Brazilian economy. Therefore in the upcoming years one can expect a change of scenery in the local private equity industry.

Mainly establishing a local branch and hiring local personnel that is accustomed to the Brazilian culture and way of doing business, since fly-in international investors could not replicate this local knowledge easily developed the learning process. International Private Equity Funds started addressing part of their global funds to Brazil, and nowadays with a better understanding of the local conditions have or are planning to start a local fund with even local resources.

There are still managerial and strategic gaps in the local Private Equity Industry, that goes again in to the fact that Brazilian investees are generally family owned business with a structure not well developed. The creation of a methodology would be interesting to apply in different cases of investment. As a recommendation it would be interesting to conduct a research with a larger

pool of respondent asking also for local private equity funds what is their perspective of the market, and asking investees how they see the strategic alliance with private equity and if they have expectations.

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