PERFORMING INVESTMENT DUE DILIGENCE IN LATIN AMERICA

RESEARCH REPORT
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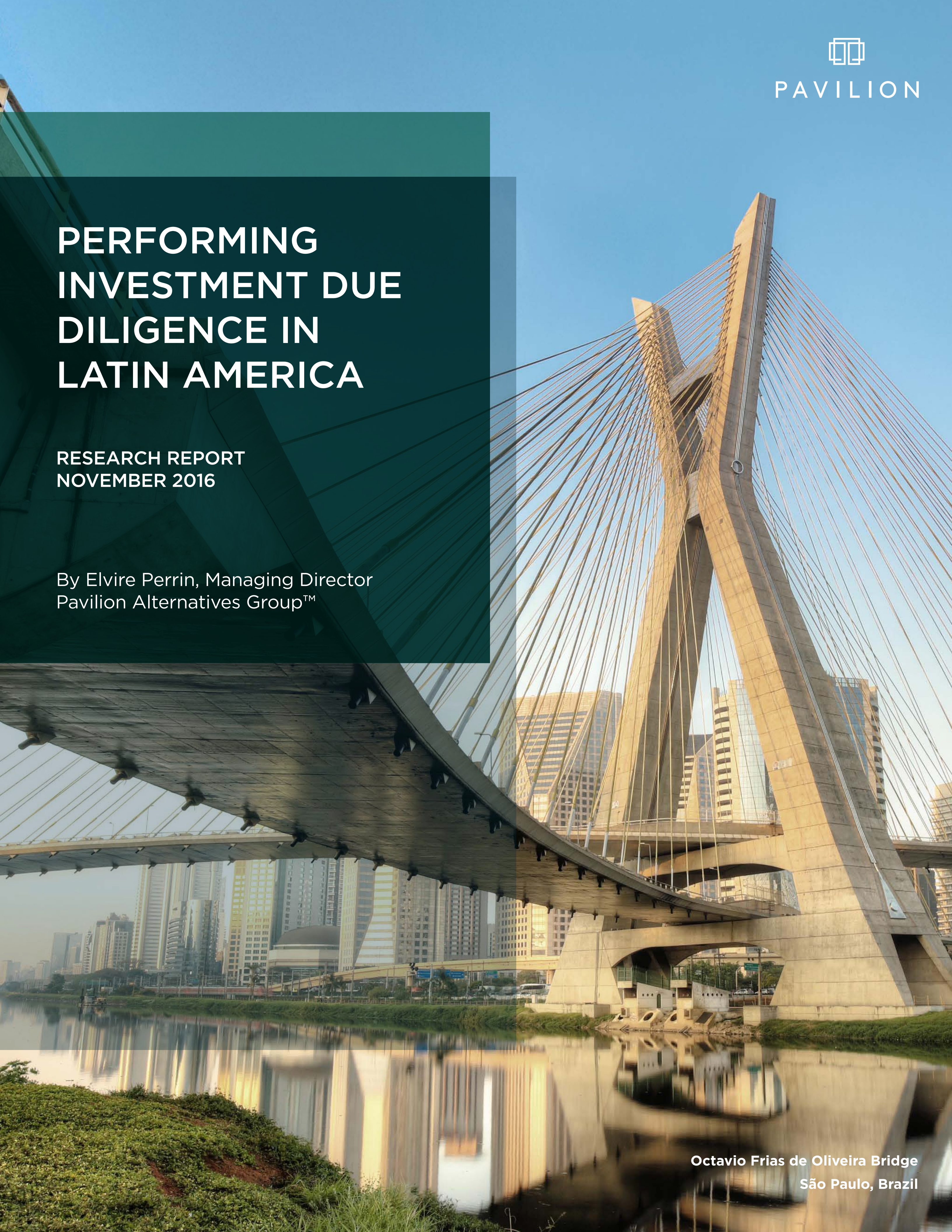

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INTRODUCTION

Latin America still represents a small share of most institutional investors' emerging market private equity portfolios. However, as results from EMPEA surveys of limited partners (LPs) show, Latin America (ex-Brazil) ranked first in 2012, 2014 and 2015, and third and fourth in 2013 and 2016, respectively, for fund investments amongst 10 other emerging market regions / countries. It is definitely a region to which LPs have been paying more attention, even if they have not been deploying substantial capital yet. In this context, providing some insight into this diversified area of the world, and highlighting a few specific due diligence points to which investors should pay particularly strong attention could be helpful for LPs looking to build or extend their exposure to the region.

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DISCLAIMER

A version of this chapter was first published in *Private Equity Fund Investment Due Diligence* by PEI. More information can be found at: https://www.privateequityinternational.com/private-equity-fund-investment-due-diligence/

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SECTION 1: IMPORTANT FACTORS TO CONSIDER WHEN PERFORMING DUE DILIGENCE ON PRIVATE EQUITY FIRMS AND CO-INVESTMENTS IN LATIN AMERICA

There are a few general points which are important to understand when performing investment due diligence in Latin America.

Latin America is not well-known for its economic stability and investor-friendly practices. In fact, the region has been through several economic and financial crises, not to mention political ones, over the past several decades. The most recent episodes are:

- the spill-over effect of the Russian crisis in 1998, which triggered a currency crisis and had major consequences for Brazil;
- the Argentinean default in 2001; and
- the current political crisis in Brazil due to the Petrobras corruption case.

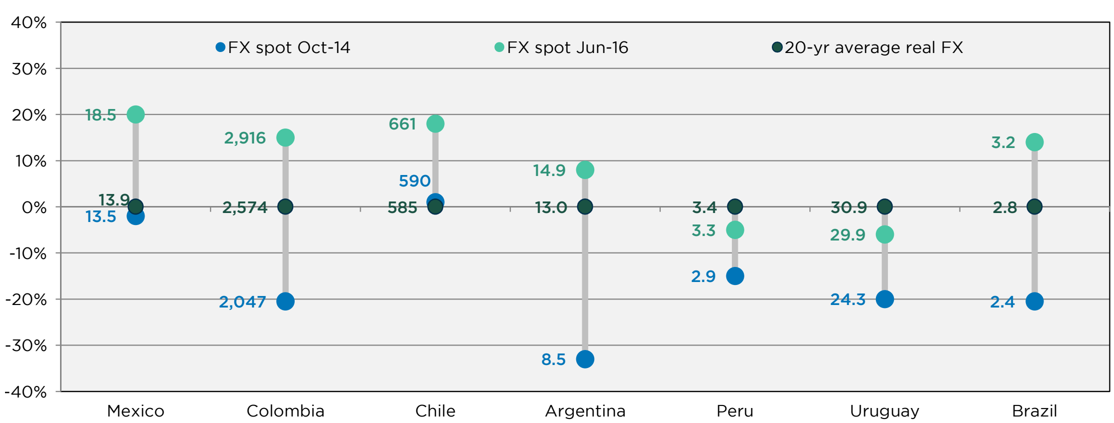
Nevertheless, some countries in Latin America have shown strong positive trends over the last 10 years. For instance, Chile, has applied a liberal economic policy for more than a decade now. Mexico, which suffered its last economic crisis in 1994, has since made clear progress towards a more liberal economic system. Even Brazil, despite the current corruption case, has made some progress towards a more open economy. Smaller countries, such as Peru and Colombia, have been transitioning from highly regulated economies towards a free economic model and have experienced strong growth in recent years. Other countries, such as Venezuela, Bolivia and Ecuador, have not shown such progress towards a liberal economic system and investor-friendly environment. Finally, thanks to the effective action of the current government, Argentina seems to be back on a sustainable and economically friendly path. For example, it has regained access to international capital markets from which it had been banned for over 10 years.

Over recent years, the region suffered less from the global financial crisis than the commodity cycle adjustment, which had a major impact on public revenues (especially for Mexico and the Andean countries of Chile, Columbia and Peru) and led to the political crisis in Brazil that was triggered by a major case of corruption. However, most of the major countries in the region have faced the challenges created by the new environment much better than in the past. We also believe that once the political crisis is over in Brazil, the country will be back on a growth pace again, with a stronger institutional base.

Currency volatility

The level of currency volatility (Figure 1) in the region is mainly the consequence of the dependency of some major Latin American countries on commodity cycles. However, the internal and fiscal mismanagement of certain local economies deserves some of the blame as well. For

Figure 1: Real FX of Major Latin American Countries



Sources:
- Chile: http://www.bcentral.cl/bde/index.htm
- Peru: http://www.bcrp.gob.pe/docs/Estadisticas/NEDD/Hojas.htm (Tipo de cambio venta promedio del Sistema Bancario / Cuadro No. 40)
- Uruguay: http://www.ine.gub.uy/preciosysalarios/cotizacion2008.asp?Indicador=cotizacion
- Argentina: http://www.bcra.gov.ar; Colombia: http://www.banrep.gov.co/series-estadisticas/see_ts_cam.htm#tasa
- Mexico: http://www.banxico.org.mx/tipcamb/tipCamMIAction.do?idioma=sp
- Brazil: www.bcb.gov.br/en.

example, during the previous decade, Argentina and Brazil had very expansionary policies, creating large fiscal deficits that required the respective countries to finance their economies through printing more money and increasing the debt level. This created inflation and weakened their currencies.

When investing in private equity, it is very difficult and not necessarily appropriate to time the market. However, investors should be aware of the currency risk they take when investing in the region.

Dependence on commodity markets

Overall, Latin America is a commodity-dependent region. The end of the commodity price boom has been a major force behind the sharp slowdown in most Latin American economies. However, the level of dependency varies meaningfully across countries.

The Bank of Tokyo Mitsubishi recently analysed the level of dependency of major Latin American economies on commodity pricing, and the summary of that analysis is presented in Figure 2.

With the exception of Mexico, the major Latin American countries have a strong dependence on commodity cycles regarding gross exports. This is mitigated for most by the limited dependency in terms of imports. Whereas Mexico's dependency for trade is limited, the nation's fiscal revenues from oil are very high compared to other countries. The other Andean countries are also highly dependent on the commodity cycle with regards to their public finance. Finally, commodity prices were, and continue to be, a catalyst for investment growth in Latin America, especially for the Andean countries.

Nascent Democracies, Corruption and the Drug Industry

Most of the major Latin American countries have gone through a democratic transition in recent years. For example, Argentina, Brazil, and Chile all returned to a democratic government during the 80's. While Colombia, Mexico and Peru were not subject to a dictatorial regime per se, they continue to suffer from the drug industry, which can be described as an illegal state within a formal one. Most of these countries are still building their democratic political system and this process has not always proceeded smoothly. Today, Brazil is suffering from a major corruption scandal. The good news is that it is being addressed comprehensively and, despite these difficult times, it should result in stronger institutions. It also means that the corruption that was ingrained in most of these countries in the 1950's, and the drug industry that started to develop in the late 1960's (initially mainly in Colombia and Peru, but later extended to Mexico), are still having negative impacts.

Based on the Global Competitiveness Index 2012-2013 by the Economic Commission for Latin America and the Caribbean, crime and violence "very much" affect the cost of doing business in the region. In 2011, the World Bank estimated the annual cost of crime and violence to the region at eight percent of gross domestic product. In 2012, the cost of crime in the region was gauged by the National

Figure 2: Level of commodity dependence of the major Latin American countries

Country	Trade		Public Finance	Investment
	Gross Exports	Net Exports	Fiscal Revenues	FDI
Argentina	High	Moderate	Low	Low
Brazil	High	Low	Low	Moderate
Chile	Very high	High	Moderate	High
Colombia	Very high	Moderate	Moderate	High
Mexico	Very low	Very low	High	Very low
Peru	Very high	Moderate	Moderate	High

Source: The Bank of Tokyo Mitsubishi.

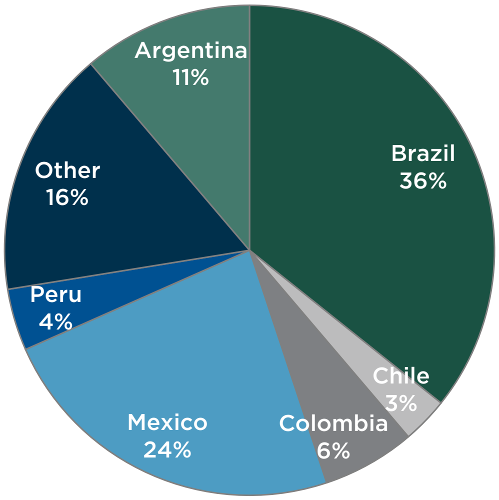
Institute of Statistics to have been $8.8 billion.[1]

Over the past decade, Latin America has demonstrated generally strong economic growth with better integration, more commitment to the weakest social sectors, and with more entrenched democratic governments. However, social mobility and inclusion have not eliminated the scourge of public insecurity. It remains, together with organized crime, money laundering, corruption and drug trafficking, paramount on regional government agendas. Public insecurity in the region continues to demand significant resources from the business community to protect its critical assets, and has a corrosive effect on the region's competitiveness in the fight to attract investment dollars. The drug industry has also penetrated the business community in certain countries where specific companies are used to launder money obtained through drug traffic.

Weight of Brazil and brief profiles of major countries

Latin America & Caribbean represented 6.2% of the global GDP in current price terms in 2014, making it a relatively small region in the world. Based on IMF estimates for 2015, Brazil was responsible for 35% of total Latin American output (declining from 41% in 2012). Together with Mexico and Argentina, these three countries represented 69% of the total GDP that year.

Figure 3: Latin America GDP by country



Source: IMF

[1] Source: FTI Consulting.

Brazil

Brazil ranks as the eighth largest economy in the world and the largest in Latin America with its young, diverse population of 200 million people. However, as a still young democracy, the country has faced many challenges in developing its economic, political, and social institutions, as illustrated recently by the Petrobras corruption scandal. With a very low savings rate in comparison to its developing peers, the country relies on foreign capital and the printing of money to finance investments in its lagging infrastructure (including real estate) and human capital as a means to increase the economy's productivity and boost sustainable and faster economic growth. Of Brazil's total population of 200 million, around 60 million people live in the Sao Paulo and Rio states, which produce approximately 44% of national GDP. These are the top states in terms of GDP per capita.

Mexico

Mexico is the 15th largest economy in the world in nominal terms and the 2nd in Latin America, according to the International Monetary Fund. Since the 1994 crisis, administrations have improved the country's macroeconomic fundamentals. Mexico was one of the Latin American nations most affected by the 2008 recession with its GDP contracting by more than 6%. Its economy is more dependent on the performance of the U.S. economy than the rest of the region. Eighty percent of its exports are to the United States. In spite of the Mexican economy's unprecedented macroeconomic stability, which has reduced inflation and interest rates to record lows and has increased per capita income, enormous gaps remain between the urban and the rural population, the northern and southern states, and the rich and the poor. Some of the government's challenges include the upgrade of infrastructure, the modernisation of the tax system and labour laws, and the reduction of income inequality.

Argentina

Argentina is a high-income economy and Latin America's third largest, after Brazil and Mexico. The country benefits from rich natural resources, a highly literate population, an export-oriented agricultural sector, and a diversified industrial base. However, Argentina's economic performance historically has been very uneven, characterized by periods of high economic growth alternating with severe recessions with increases in maldistribution of income, and poverty. The recently elected business-friendly government is in the process of reversing the negative impacts populist policies have had on the economy over the last 15 years, mainly in terms of inflation and access to international capital markets.

Andean Region (Chile, Peru, Colombia)

These three economies have made very clear progress toward market friendly economies: Chile starting first in the early 1980s; and Peru and Colombia more recently in the 2000s. Despite their relatively strong dependence on commodity prices, they have been run by reasonable governments which have promoted market reforms. Colombia and Peru have made tremendous progress in fighting the drug industry and left-wing revolutionary groups which had major negative impacts on their economies, culminating into a Peace treaty with the FARC (the main guerrilla group in Colombia) signed in June 2016. Despite the fact that the treaty was not approved by the population at the time of the referendum in early October, this still illustrates the tremendous progress made. Eventually, after further negotiations taking place, we expect the treaty to get approved.

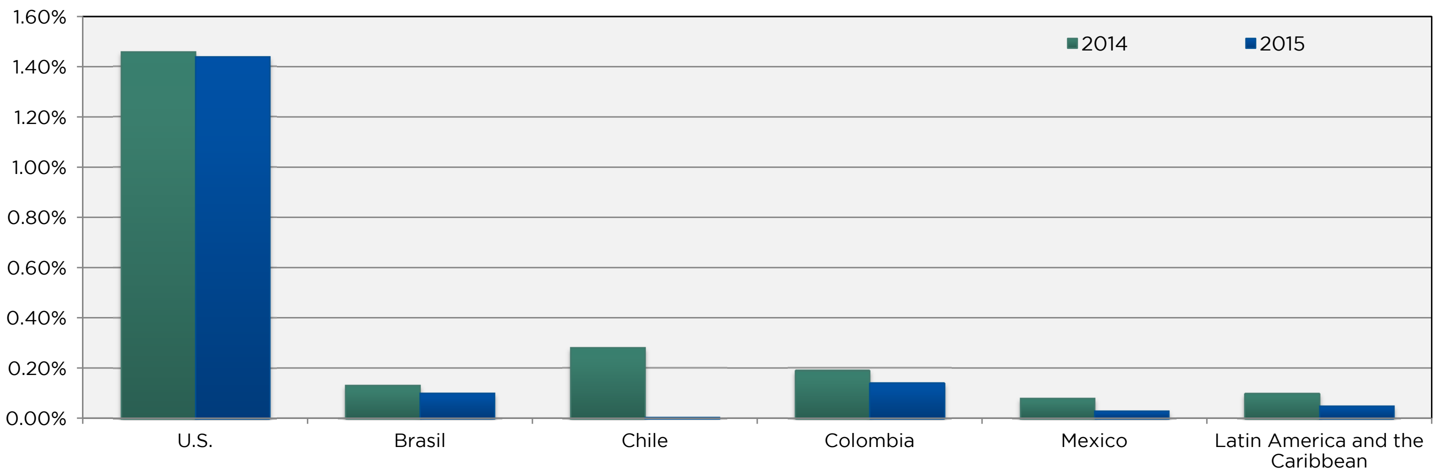
Venezuela, Bolivia, Ecuador and Paraguay are frontier markets and, as such are unlikely to be considered by investors; Venezuela because it has become a lost state, the other three because their markets are small and their business ecosystems so limited that private equity firms can hardly develop a business there. Also, Bolivia and Ecuador have suffered from very left wing and populist governments.

The development of private equity in the region

In the early 1990s, a wave of privatization in Latin America attracted foreign capital. Regulations also broadly changed to facilitate private ownership. Between 1993 and 1995, private equity funds started to appear. These included country-focused funds, mainly in Argentina, Brazil, Mexico and Chile, and regional funds, mainly headquartered outside of Latin America (mostly from the U.S.). The majority of the private equity transactions at that time were minority deals with poor valuation discipline and weak business planning. For the regional funds, in addition to these shortcomings, most of the decision takers did not have a full grasp of the economic realities of the countries in which they were investing. Consequently, the vintage years from 1995 to 2002 generated poor performance and many of the active fund managers at the time disappeared. Since then, a number of private equity firms have adjusted their strategies towards: more hands-on, control deals; teams on the ground; and locally-based decision-making power. New teams were established by professionals previously in charge of their family offices or from the spin-out of private equity investment bank teams. This has created an environment conducive to developing the more prosperous private equity environment that exists today.

Pavilion Alternatives Group estimates the Latin American private equity market consists of between 80 and 100 fund managers. Roughly half of these are institutional-quality managers, a much smaller sample than in emerging Asia. The vast majority of these managers apply growth and buyout strategies, but there is also a nascent venture capital industry, mainly in Argentina, Brazil and Mexico. As the chart below shows, the penetration of private equity is still very limited in the region overall.

Figure 3: Latin America GDP by country



Source: EMPEA

SECTION 2: PERFORMING INVESTMENT DUE DILIGENCE IN LATIN AMERICA

General points

Conducting due diligence on private equity funds in Latin America is not that different from conducting due diligence on a U.S. or European-based fund in terms of the general due diligence process and the important areas to cover. However, as explained above, the region has certain nuances that are important to take into consideration when performing due diligence. We will focus on those specific nuances rather than the generalities in the following section.

The general points to cover in due diligence include:

- **Investment analysis:** team, strategy, track record, market, peer comparison, and terms and conditions
- **Operational analysis:** back office systems, principals' background checks, valuation and conflict policies, reporting process, and other regulatory aspects
- **Environmental and social governance:** at the manager level and portfolio company level

Nuanced areas to cover in due diligence

Team and background

Overall, there are three major types of private equity fund managers in Latin America: the ones set up as a spin out from a larger bank/financial institution (Linzor, Australis, etc.), the ones that are an affiliate of a larger and more global private equity firm (e.g.: Abraaj, Actis, Advent International, Carlyle, General Atlantic) and finally the teams whose roots are the principal's family office business that he/she decided to turn into a more institutionalised investing entity (Nexus in Peru, Pampa in Argentina, etc.) – or where the principal was investing a family's capital and decided to start raising third-party capital on the back of the track record achieved (e.g.: Southern Cross in Argentina, the Axxon Group in Brazil, and Teka in Colombia).

For the first group, it is generally pretty simple to analyse the team dynamic and chemistry. Most of the senior team members should have been working together before, and track record attribution would be quite clear given that the majority of the team in charge of the investment activity would have left to set up the new firm. The important point to look into, though, is potential succession issues and making sure that the older generation transfers the knowledge and expertise to the second generation for it to be prepared to take over when the time comes.

For the second group of private equity firms, attribution of track record is usually more complicated, given that most of these firms have gone through a certain level of turnover, over time. LPs therefore need to make sure they understand how deals were staffed and who was responsible for what activities in order to make sure that the most talented individuals are still involved in similar capacities. For this type of firm, it is also important to understand how the investment decision process works. Potential investors should make sure that the partners on the ground keep most of the decision power locally, and that the process is flexible enough to avoid losing deals due to inefficient or indecisive processes. Maintaining the decision-making power outside of the region is essentially what brought down certain Latin American funds in the late 1990s (e.g.: Hicks Muse Latin America). The investment decisions were mainly under the responsibility of professionals who did not understand the complexity of the local environment and team culture dynamics. This model failed.

For the third group of firms, the focus should be on understanding the principals' ability to source deals outside the Family Office network, as well as analysing the risks involved with the deals they are targeting. The typical Family Office would generally be more open to riskier deals because it believes that it has enough information to mitigate such risk, or is ready to manage more concentrated portfolios. For this last major category of firms, understanding how the fund manager looks into portfolio construction and risk mitigation should be a critical part of the due diligence.

Investment strategy and sourcing

As we have seen in the first section, several of the Latin American countries have gone through specific crises which have had various impacts on their local economies.

Understanding the investment strategy of the fund / firm, the geographic scope and the level of risk associated with it, should therefore be an important part of the due diligence analysis.

Given the level of volatility in the region overall and the commodity price dependency of several countries – as well as the small size of certain economies - a narrow geographic focus is a source of higher potential risk in our view.

There are two countries where a single country focus seems appropriate: Brazil and Mexico, mainly due to their size and the level / quality of investment opportunities. However, even there, as the current situation of Brazil demonstrates, the largest countries in the region are not immune from high levels of volatility. A fund solely focusing on one of the smaller countries could make sense, but this would depend on the sourcing ability of the fund manager and its ability to navigate through economic cycles; a fund solely focused on any of the smaller countries will come with a higher level of risk.

Targeting the Andean region as a geographic focus is an example of a way to mitigate risk, where the fund manager balances the risk of highly commodity dependent countries (Chile, Peru and Colombia) with Mexico, which is much less dependent and follows a growth pattern more correlated with the evolution of the U.S. economy. More importantly, it increases the pool of quality investment opportunities. Through the Pacific Alliance, several trade agreements exist between these countries as well as with Asia, and this creates a dynamic business and trade environment. Buy-and-build or roll-out investment strategies can be very efficient ways to create value for investors.

Sourcing is also an important aspect of the strategy. There are countries, such as Mexico and Chile, where a very large part of the small and mid-sized companies are controlled by a few local families. Therefore, in these two countries, having access and being connected to these families is a prerequisite to getting a healthy deal flow. In other countries such as Colombia and Brazil, the local and international advisory ecosystem is pretty well developed. Therefore, a larger share of the deal flow is intermediated. It also means that it is generally harder in these countries to get access to a highly proprietary deal flow.

Due diligence process

As explained in the first section, corruption and drug trafficking are a part of daily life in several Latin American countries. The link between the drug industry and the business community - in which specific companies are used to launder money obtained through drug traffic – requires the private equity fund manager to carefully source its deals through reliable and trustworthy paths, and to perform very deep background checks on the companies it intends to acquire. During the due diligence, it is paramount to understand the fund manager itself, its partners' backgrounds, its network of contacts, the quality of the intermediaries from which it sources its deals, and the external parties with which it works. It is also critical to understand the process that the fund manager uses to perform checks on the potential portfolio companies, what type of external forensic help it is getting, as well as the reputation and track record of the firms used in this process.

This is closely related to the "Governance and Social aspects" of the ESG approach and policies that the fund manager has in place to manage its own firm as well as its portfolio companies. It is therefore very important in our view to fully understand the fund manager's position on ESG and the internal operational processes in place, in order to mitigate potential corruption or other related risks. Specific attention should be put on the following points:

1- Reviewing providers of back office and administrative services and how the fund manager interacts with them;

2- Understanding the firm's support functions, including HR, compliance, finance, administration, etc.;

3- The fund manager's ESG expertise and whether the expertise is internal or provided by external consultants;

4- Understanding the fund manager's Responsible Investment Policy and how ESG factors influence the investment process;

5- Reviewing how ESG factors are incorporated into internal audits at the fund and portfolio company levels; and

6- Reviewing the processes in place to ensure ESG issues are managed at the portfolio company level and are monitored during the entire holding period, until the exit.

Track record in local currency vs USD, and benchmark

Given the pronounced currency volatility level that several of the Latin American countries have been under, it is critical when analysing the fund manager track record to look into both the USD-denominated track record as well as the one denominated in local currency. Looking into the USD performance only would limit the depth of the due diligence, given the impact that such currency volatility can have on a fund manager's track record. We therefore recommend requesting underlying statistics for all portfolio companies and exited investments from the fund manager, in local currency at entry and at the latest valuation date or exit date, depending on the case. By analysing this data, the potential investor will have an accurate picture of how these companies effectively have been performing.

It is also important to combine the local currency analysis with the USD performance of the fund. This enables the potential investor to compare the fund's performance with other Latin American focused or emerging market funds more broadly, as the currency volatility should be a risk element that the investor takes into account for its investment decision. Only the USD performance can be benchmarked with data providers such as Burgiss or Capital IQ. Given the lack of any local currency benchmark database, the sample for the benchmark in local currency will need to be constructed by the investor, by taking into account other funds which were raised and invested in the same country / sub-region, over the same time frame. This might change as local currency data providers, such as Private Equity Bay in Brazil, are starting to develop local currency benchmarks.

Impact of the macro economic and political environment

Sometimes the quality of the fund manager and its operating capabilities will not be enough to face specific crisis situations. For example, a few fund managers disappeared shortly after the Argentinean default, caused

by the collapse of the convertibility system which had fixed the local currency with the dollar at a 1:1 exchange rate. The collapse of the local economy was such that the fund managers that focused mainly on investing in this country were impacted dramatically. This is another example that illustrates the level of risk to which investors are exposed when investing in funds focusing on specific countries – especially when the historical records of such countries have not been very strong.

Excluding these extreme cases, it is more critical for fund managers focusing on Latin America to have:

1- A very strong discipline with regards to acquisition prices, as entering into businesses at reasonable or below-market prices will provide a cushion if macro-economic volatility impacts the fund's underlying companies. It is therefore highly recommended to analyse the fund manager's attitude and strategy with regards to this important variable. It is expected that pan-regional funds will feel less pressured to invest in a single country than single-focused funds if they cannot find deals at reasonable prices. They can always deploy in other countries they find more attractive.

2- A very high level of operational experience or connections with managing talents with experience navigating through the cycles and crises of targeted Latin American countries. The good news is that most of the C-level managers with experience in the region have acquired unique experience having to adapt to very volatile and complex situations. During the due diligence, the potential investor should look into the way fund managers source the operational expertise and positions for their portfolio companies, what networks they tap into, and the experience of the managers they recruit to run their portfolio companies, as experienced management teams will be critical for the success of each underlying investment.

CONCLUSION

Conducting due diligence on private equity funds in Latin America is not fundamentally different than doing due diligence on a U.S. or European-based GP. The main differences to take into account rest on the macro social, political and economic environments in which the fund managers are investing. These create challenges that most developed markets do not face. The macro-economic volatility, nascent democracies, and importance of certain countries in the region are all important elements to take into account given that these factors influence the way LPs should implement due diligence in this small but promising area of the world.

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