ALTERNATIVE LatinInvestor

Issue 20 - February / March

Private Equity Special Issue

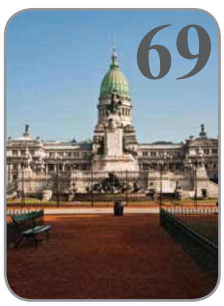
Does Liquidity Deserve a Premium?

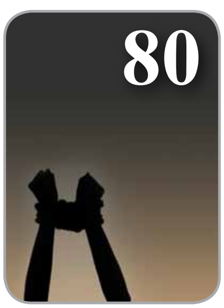
How Chinese Regime Change will Affect LatAm

Perspectives for 2013 in Brazilian Oil and Gas

Contents

Sectors





Issue Focus: Private Equity

Cover Stories

For this first issue of the year, it is my greatest hope that our readers are off to a productive and profitable 2013. While the coming of a new year affects the global business community, I see its impact diminished within the emerging markets and particularly Latin America due to the dynamic and constantly changing nature of the region. With new, exciting, terrifying, surprising events taking place on a weekly basis, who has time for resolutions?

The year has seen the solidification of the idea that Argentina has decided to move forward with its current FDI-adverse policies and there is nothing the global investment community can do about it but continue to enjoy the wine and carne — not a bad alternative. The health of Presidente Chavez is at the top of many people's watch list, the outcome of which could have a dramatic impact on the Andean business landscape. With the Brazilian slowdown, capital is starting to be deployed in increasingly LatAm 'ex-Brazil' strategies, though the regional powerhouse cannot be counted out. It is and will continue to be a strong part of LatAm portfolios.

Slower than anticipated recovery in the US and European markets have been favorable for LatAm investments, in addition to growth in capital inflows from non-traditional regions, Asia and the Middle East. With such different cultures, as well as a very relationship-based investment methodology, this is a very promising sign for Latin America creating a more robust business ecosystem. The growth of the private equity sector we find key to alternative assets, not only for PE investors, but also because increased investment in a greater number of companies will lead to an eventual greater number of exits, a greater number of IPOs, and as such give the local equity markets more diversity and trade volume for giving hedge funds a greater ability to maneuver, thus bringing better returns to their investor base.

Brazil is even looking past the region as BTG Pactual Group announced in 2012 plans to raise $1 billion for what will be Africa's biggest private equity fund. To see an emerging-market country begin placing capital outside its region and geographical comfort zone is a very exciting step in the evolution of Latin America and one we will be watching closely.

Saludos,

Nate Suppaiaih
Managing Editor
202-905-0378

2013

Brazil

Oil & Gas Industry Perspectives

Mark McHugh and Luiz Antonio Maneschy

Brazil is heralded as the largest and most significant new oil and gas prospect of the last few decades. However, there is still a long way to go to realize the promise of a new non-OPEC stable source of supply in the top 5 world oil producers by 2020.

Progress toward this ambitious target has been slow in the last year, as project development, execution and political risks have taken their toll. Meanwhile, after 2 years of modest growth, the Brazilian economy is looking forward to a more positive business climate in 2013. In parallel there are plans to hold new oil and gas exploration licensing rounds in May and November 2013, which should give the industry a much needed boost. Petrobras remains the key driver of the industry, as it still represents over 90% of production in Brazil. Yet the outlook for the next couple of years is challenging for Petrobras, with increasing demands placed upon it by government and the need to meet more realistic targets. The emphasis is now on the transition to field development and bringing new production on stream. While this process is ramping up in 2013, it has yet to achieve critical mass, notably for the deep-water pre-salt development. It will not be for another couple of years that the industry in general will start to capitalize on their exploration programs and contribute to a significant share of the projected 5.7 million boe/d production by 2020.

General Economic Outlook in Brazil

After the dramatic growth rates of 2010, the Brazilian economy continued its significant slowdown in 2012, with GDP growing at around 1% annually, versus an expected growth of 3.3% at the beginning of 2012.

Finance Minister Guido Mantega in a recent interview predicted a return to strong

growth during 2013 after 2 years in the doldrums, and the market is anticipating a 3-4% increase in GDP.

The principal factors leading to poor global economic performance in 2012 were:

- General risk aversion in the world economy;
- Slow recovery of economic activity in the USA;
- High levels of European unemployment;
- The risk of default among European countries;
- Slowdown of the Chinese economy; and
- A fall in the price of commodities.

This in turn impacted the Brazilian economy with:

- Decreased performance of export manufacturing;
- Increase in manufactured imports;
- Drop in the exports of mineral commodities;
- Weak performance of the Brazilian stock market;
- Significant increases in salaries and a shortage of specialized labor;
- The end of strong consumer credit growth;
- Lower than anticipated investment levels; and
- Brazil losing its position as the world's 6th economy to the UK.

The investment climate is expected to improve in 2013, partially catching up on the backlog and partially in advance of the World Cup in 2014 and in preparation for the Olympics in 2016. The government is planning to spend R$43 billion on infrastructure during 2013 and to stimulate the manufacturing industry. The cities of São Paulo and Rio de Janeiro alone anticipate investments of R$6.5 billion and R$3.9 billion, respectively.

Some leading financial indicators for 2013 are:

- After its weak performance in 2012, the stock market expects a volume of R$20 billion in IPOs in 2013.
- The level of direct foreign investment will remain high (above R$60 billion).
- The M&A market will be active (at about 800 operations a year).
- Private equity investment will be in the range of R$6 billion (Source: ABVCAP).

As the world's second-largest developing economy after China, Brazil is a key indicator for the economic health of the emerging world and a major source of growth, as Europe, the US and Japan wrestle with major debt problems. Inevitably, a number of uncertainties in global markets will remain during 2013, which can impact Brazilian business and the expectations for the year.

As the world's second-largest developing economy after China, Brazil is a key indicator for the economic health of the emerging world and a major source of growth, as Europe, the US and Japan wrestle with major debt problems.

Other predictions for 2013 in the Brazilian market are:

- The unemployment rate will continue to fall;
- Salary increases will continue;
- Retail price inflation will be impacted by higher food prices;
- A return to the IPI freeze on vehicle sales;
- Continued poor performance of Brazilian manufactured exports;
- A growth in the retail trade of 7.5% (Source: CNC);
- The implementation of the Basel III agreements will concern midsize banks; and
- Brazil will regain its position as the 6th largest world economy.

During its slowdown, Brazil introduced a succession of measures, including a move to weaken its currency and one to cut what were once among the world's highest interest rates to a record low of 7.25%. With these changes in effect, the prospects of a stronger year for the Brazilian economy seem to be underpinned by the fundamentals.

Key Trends for Global Oil Markets

More than usual uncertainty about the economic drivers of energy markets complicates forecasts for oil demand and pricing in a year of continuing relocation of the growth of supply and demand. Global demand for energy in general and oil in particular remains strongly linked with economic performance — about which large questions loom and their answers dependent on actions by policymakers in the US and Europe. Recent resolution of the fiscal cliff is positive in that fears of a US recession are now fading, although further deadlock in Congress on US tax issues cannot be entirely ruled out.

The global benchmark Brent crude average ended 2012 at about $112 a barrel, adding 3.5% annually, down from the 13.3% jump in 2011. The American benchmark index, West Texas Intermediate (WTI) fell $7.01 per barrel, or 7.1% over the year.

It is expected that global economic uncertainties will continue to drive price volatility. Beginning in 2013, analysts remain doubtful about the oil price movements, as much of the previous year's concerns are expected to carry over this year. Credit Suisse slashed the price outlook of WTI by 5% to $102.75 from $106.00 per barrel while retaining the global benchmark Brent crude at $115. Barclay's analysts are a bit more bullish, estimating Brent prices to reach up to $135 by year end. Economists at Capital Economics suggest that Brent crude could remain at $85 by the end of the current year, a sharp drop of $27 while WTI could reach $75.

The Oil & Gas Industry in Brazil

Against this backdrop Brazil's oil and gas industry in Brazil is seeking this year to rekindle its progress toward the ambitious goal of daily production of 5.7 million barrels by 2020.

Petrobras

Petrobras President Maria das Graças Foster at the beginning of 2012 put the company's plans on more realistic footing. Under her leadership Petrobras now focuses heavily on delivery of one of the world's most ambitious capital programs, targeting $236.5 billion expenditure during the period 2012-2016. However, Petrobras continues to be held hostage by its largest shareholder, the Brazilian government, and is used as an instrument of government policy rather than having the freedom to make fully commercial decisions. Moreover, it has suffered a number of setbacks on both production and project delivery, with high levels of technological complexity to develop the deep-water offshore resources in the pre-salt. Consequently, in mid-December, Moody's cut its credit outlook for Petrobras, providing some key reasons:

Against this backdrop Brazil's oil and gas industry in Brazil is seeking this year to rekindle its progress toward the ambitious goal of daily production of 5.7 million barrels by 2020.

- Petrobras is significantly outspending cash flow and its production has fallen short of target, with crude production in Brazil averaging 2.59 million boe/d in the first 9 months of 2012, down about 0.5% relative to 2011.
- Petrobras continues to face a number of conflicting pressures. Rising oil product imports and government fuel price controls are resulting in large downstream losses, implementing a local content program against the background of a high "Brazil Cost" for local manufacturing and services.
- In 2013 Petrobras faces rising debt levels, increasing cost pressures and execution risks in keeping development projects and production targets on track and achieving cost savings.

The outlook for the next couple of years will be tough for Petrobras. It must avoid excessive political interference and deliver medium-term on profitable production and reserves growth, with a decline in its leverage profile to successfully meet the target it has set itself to become one of the world's top 5 oil producers by 2020. Many industry observers are questioning whether Petrobras is up to the challenge. During 2013 Petrobras needs to create confidence that it is in control of its own destiny and demonstrate its ability to deliver. There are some encouraging signs: with entry into production of 3 new wells, Petrobras' total pre-salt production was 2.72 million boe/day in November 2012, a 25.6% increase on the previous year, but still well below the potential. Brazilian self-sufficiency in oil production and refined products was lost in 2008 and is unlikely to be recovered before 2020, according to Petrobras itself.

Brazilian Independents

Meanwhile, Brazilian independent exploration companies such as OGX, HRT and Queiroz Galvão have been hit particularly hard during 2012, as investors flee from the hype and uncertainties of the sector. With large exploration portfolios and low levels of production these companies must now consider farm-ins in order to obtain additional capital, operational capability and more importantly to offset some of the execution risk. Under the right conditions — with a successful realignment of strategy and further exploration success for companies like HRT — the independents' share prices have the potential to rebound during 2013.

IOCs

There are many international oil companies (IOCs) with activities in Brazil, including Shell, Exxon-Mobil, Statoil, BG, Chevron, BP, Maersk, Total, Sinochem, ENI, Anadarko, Repsol, Sinopec, Petra, El Paso, Galp Energia, Ecopetrol, Hess, Sonangol, among others.

The IOCs remain disappointed with the Brazilian government, primarily because of the new Petroleum Law introduced in 2009, which dictates that pre-salt reserves are to be explored and developed in partnership with Petrobras, which has a minimum interest of 30% in any given consortia. In addition, the law declares that Petrobras can be awarded pre-salt exploration contracts without a competitive bidding process. Yet Petrobras has been unable to meet their annual production targets, despite an 11% cut in the forecast for 2020.

With the IOCs are constantly seeking to improve their reserve replacement ratios on a worldwide basis, Brazil potentially has a tremendous role to be play, with some of the largest discoveries in recent decades. However, the lack of new bidding rounds from the Brazilian authorities over the last 4 years has impeded new exploration and has created an active secondary market with more than 50 farm-in and/or farm-out contracts negotiated between 2009 and 2012. Companies were complaining that they are running out of areas to explore, with concessions from the 10th round in 2008 starting to expire. The recently announced ANP rounds during 2013 are long overdue and are expected to create significant interest within the industry.

Some recent highlights of activity from the sector are:

- Shell is the leading producer other than Petrobras, with around 100 Mbpd today and this figure should increase by 30 to 40 Mbpd in 2013.
- Although Statoil sold 40% of the Peregrino field to Sinochem, their midterm plans for Brazil are quite aggressive, with US$5 billion to $10 billion investment planned during the next 2 years.
- BG is planning to invest US$25 billion in Brazil until 2020, with US$2 billion focused on Research & Development, according to their CTO, Olivier Wambersie in a recent interview.
- Chevron has been in a critical situation since the Frade oil spill incident in the Campos Basin.
- BP, which bought out Devon's blocks in 2010 for $3.2 billion, is seeking to focus on its discoveries in the deep waters of the Campos Basin and exit its only producing asset, the Polvo field.
- Maersk has invested around US$3 billion during the last 5 years in their 6 blocks.

- Exxon/Mobil has already explored around 200 km and is still interested to explore more areas.
- Meanwhile Anadarko has left after failing to find oil.

Government reactions to Chevron's accident in 2011, and its political interference in Petrobras, continue to create suspicion among investors, according to Joao Carlos De Lucca, President of Brazilian Petroleum Institute (IBP). Despite this, it is anticipated that high levels of portfolio activity will continue into 2013 and there will be a fierce interest in the new bidding rounds from IOCs and independents alike.

Oil Field Services

In the oil field services sector, the local content program has been successful in encouraging equipment and service suppliers, be it local drillers, services or equipment companies, to invest to meet the big pre-salt needs. However, some of those providers are waking up with a slight hangover, as Petrobras, under Graças Foster's new leadership, has toned down drilling and production targets to more realistic levels. Consequently, there is the potential for service overcapacity in Brazil that will likely give Petrobras the upper hand on service pricing in years to come. Equipment manufacturers appear in better shape with bottlenecks in both subsea trees and tubular (rigs are waiting extensively on both trees and casing).

Brazil rig demand is robust, despite likely near-term softness driven by equipment constraints. So, while Petrobras might release some mid-water rigs in 2013, the company appears fully committed to its portfolio of 40 ultra-deep water rigs, and we believe Petrobras' total rig fleet could grow a quarter by 2016. See table with the comparison of offshore vessels/ equipment backlog orders.

Exploration drilling is currently starved, but resumption in Brazil's bidding rounds should change this in 2014. Cost inflation is also finally easing up, while local rig construction remains challenged, so the midterm driller outlook still remains quite constructive.

Service majors are accepting lower margins to access Brazil's long-term potential. The pricing battle among Big 3 remains intense, with Petrobras succeeding in knocking down prices on major service contracts.

New ANP Rounds

Brazil's President Dilma Rousseff on January 10th signed off on plans to hold a new oil and gas exploration licensing round, which will probably be held by May 2013, or earlier if possible, according to Mines and Energy Minister Edison Lobao. The minister said this 11th round, the first license auction to be held since 2008, will include some 164 blocks, of which half are offshore and half are onshore.

ANP, the regulatory body, expects a high level of interest in the 11th round of blocks, mainly due to the recent discoveries by Petrobras near to areas that will be auctioned. The appetite is also related to significant discoveries made by Petrobras in the equatorial margin and in Guyana, which is analogous to the coast of Africa, and has very similar geological structure. Companies like Shell will look with great interest on areas in the 11th Round, according to their President in Brazil, Andre Araujo.

The first round of licenses for the so-called sub-salt region, where massive oil reserves have been discovered in recent years, is on track to be held in November. The sub-salt round will be held under a new set of rules which determine a larger role for Petrobras. Meanwhile, it is not an easy task for Petrobras to be almost obliged to participate in all 10 previous rounds, but to now be required to have a minimum of 30% in all the pre-salt blocks, and also to become the operator of these areas. This will potentially stretch even further the capabilities of an already stretched Petrobras.

In the next rounds, the licensing procedure should be more streamlined due to an agreement between ANP and IBAMA, in which environmental licensing is now by area and not for each block.

Political barriers and the issue of distribution of royalties between the Brazilian states left the country without auctions for almost 5 years, awaiting a new regulatory framework, which is due to be voted on now in early 2013.

The lack of new exploration rounds has been a missed opportunity for Brazil and has undoubtedly led to investment in other regions. According to ONIP, oil companies like Exxon/Mobil, Shell, Statoil, Chevron and other producers were left outside the area of the pre-salt offshore, which contains at least US$5 trillion in oil. Delays have also led companies to look elsewhere for new discoveries, such as Total and BP in West Africa, OGX in Colombia and HRT in Namibia.

Nevertheless, expect to see major international focus on Brazil during 2013 because of the new exploration rounds, not only from existing players, but also from new participants anxious to participate in a strategic new stable source of supply and in a strengthening economy, while global oil markets remain volatile. 2013 is a year for the oil and gas industry in Brazil to regain some of the momentum it has lost in the past couple of years.

AUTHOR BIOGRAPHY

Mark McHugh - is a Managing Director and Co-Founder of OFS Capital, LLC a boutique investment firm, with offices in Houston and Rio de Janeiro, focused on the oil and gas sector in Brazil and Latin America. Mark is actively involved in dealmaking and consulting in the energy business globally. He is based in Brazil and has an extensive international senior-level career in the oil industry in marketing, sales, strategy consulting, and general management, spending 26 years with Shell. During his distinguished career, Mark has held a variety of management team positions as VP Marketing Americas, GM Downstream International Consultancy, VP North Latin America and GM Shell Venezuela.

He has an exceptional track record in leading new business development, implementing global business strategies, M&A and managing startups. As an entrepreneur and investment advisor, he is currently working on a pipeline of over US$800 million of energy deals. He has undertaken a number of market-entry studies for international companies looking at the Brazilian market. Mark graduated as a mechanical engineer from Imperial College, London and has a postgraduate qualification in finance and business administration from the University of Westminster.

For further information on this article or OFS Capital, please contact: mmchugh@ofscap.com.

Luiz Antonio Maneschy - Luiz is a Managing Director and Co-Founder of OFS Capital, LLC. He is an experienced senior oil industry executive and consultant, with emphasis on strategy development, design and improvement of processes, elaboration of procedures, norms and policies, personnel management and company training. He is equally at home in the operations and commercial areas.

Luiz has outstanding experience in both Brazilian and international roles and has worked in Europe, the United States, the Caribbean and Central America. In the latter he restructured and grew Shell's aviation businesses, leveraging sales and profits, and improving operations with sustainable results.

With more than 30 years of experience in Brazilian and multinational companies (Fugro and Shell), he has held positions as General Manager, Finance & Administration Director, Director of Industrial Operations, Corporate Director of Health, Safety & the Environment, as well as positions in Sales, Operations, Supply Chain, Engineering and Quality. Among his recent clients are Petrobras and ABESPetro (Brazilian Oil Field Services Association). He is a graduate in mechanical engineering from the University of the State of Rio de Janeiro (UERJ) and also has an MBA in Business Management from IBMEC in Rio de Janeiro, as well as having completed diverse courses with the Shell Group.

For further information on this article or OFS Capital, please contact: lmaneschy@ofscap.com.

Liquidity Premium in LatAm Real Estate Private Equity

James Anderson

A seldom discussed theme in Latin America private equity markets is liquidity premium, or the excess return an investor can reasonably expect to sacrifice by investing in more liquid assets. Another way to think about this is the illiquidity discount associated with private equity investments, including direct real estate investments. We contend that the current market view that less liquid equates to better returns is incorrect and it is only a matter of time before institutional investors begin to take notice that the industry lacks alternatives to the current PE model.

Ample research on comparative real estate returns in the United States has shown that direct investments do not necessarily outperform public investments. One study, conducted by University of Wisconsin's Timothy Riddiough, observed that publicly traded US REITS outperformed non-REIT managers by over 300bps between 1980 and 1998 (10.44% annualized vs. 7.36% annualized). Similarly, another study from MIT over the 1995 to 2005 period saw US REIT returns of 13.1% versus non-REIT manager returns of 10.6%. Both studies adjusted leverage, fees and property types.

In both instances, the conclusion was quite simple: illiquidity doesn't guarantee excess returns and, in fact, has meant lower returns. Brad Case, Head of Research at NAREIT, wrote in 2010, "REIT managers outperformed managers of illiquid, value-added real estate funds by 56 percent, and opportunistic funds by 11 percent, even while taking less risk with their investors' capital." It is no wonder that US private equity real estate managers are now talking about adding non-real estate assets, such as RMBS, to their mandates.

In Latin America, we have seen no quantitative studies that measure what a real estate investor can reasonably expect in terms of premium by locking up capital in a direct investment. In fact, nobody even tracks private equity returns in the region – including Preqin.

There are many reasons for this, including unwillingness on the part of managers to share data, underdeveloped equity and debt markets and, we suspect, a vested interest in maintaining opacity which benefits participants. If there is to be meaningful research, it will not be from the managers of investment vehicles, but from the investors themselves or perhaps potential new managers such as hedge funds, fund of funds and quant managers.

A Fresh Perspective

Tierra Capital Partners has developed 3 sector-specific indexing methodologies aimed at measuring risk-adjusted return benchmarks for the real estate, infrastructure, energy and materials industries. The principal challenge to creating the indices was the degree to which Latin America's public markets are positively correlated. To solve the correlation problem, we created composite weightings that draw from all public data instead of simply weighting market cap changes. We believe our methodology captures value changes that are not effectively reflected in the public equity markets and which may provide a measurable link between the public equity markets and regional direct investment performance since our results are summarily less correlated to the overall markets.

We contend that the current market view that less liquid equates to better returns is incorrect.

Our approach introduces a viable benchmark and proxy for private equity real estate managers and, our contention is, to the extent a manager's results trail our indices, that manager should be classified as an underperformer.

To begin our analysis of what the appropriate discount should be for real estate direct investments, we needed to derive the discount an investor would expect from an illiquid security versus a widely traded liquid investment.

In an October 2012 presentation at the Alternative Investments Conference in Chicago, Mark Goldberg of Carey Financial, LLC, estimated the average expected discount for the US market to be 28% for the period 1997-2005 (with a range of 25% to 45%). In other words, if a widely traded security yields 10%, an investor would be willing to purchase a comparable illiquid security for a 14% yield (approximately 40% more return).

For a direct investor, this premium is normally realized in the form of asset appreciation, whereas for the widely traded markets, a large percentage of return would be current yield plus some asset appreciation. In Latin America, most direct investments are opportunistic, deriving most gains from capital appreciation. That said, as large investors become more comfortable extending exit timeframes for stabilized property types, especially industrial and office, they are effectively converting into core investors. The growing interest in core strategies in the region will make benchmarking with the public markets even more plausible since core returns generally rely upon current yield.

We examined the period 2007 through 2012. Over this time frame the MSCI US REIT index and the NCREIF returned approximately 2.5% and 4.8% annualized, respectively. The S&P 500 returned -0.6% annualized. The Latin America ETF index (ILF) returned 3.5% annualized. A rough, back-of-the-envelope estimate of the liquidity discount for direct real estate investments over this time frame is 45% if we are to use the MSCI US REIT and NCREIF returns as reference points. In other words, if an investor were to invest with the benefit of hindsight, that investor would expect a 45% discount to invest in an illiquid asset or they would have underperformed the actual returns.

Interestingly, the 45% discount is in line with the upper range of discounts that were discussed in Mark Goldberg's presentation cited above.

Turning to Latin America, since we know the broad regional equity ETF ILF returned approximately 400bps more than the S&P 500, an investor in real estate should expect at least 6.5%, in USD, for a widely traded real estate equity in the region. Discounting at 45% suggests a private real estate investor would have required about a 12% return, in USD, for a direct investment in Latin America over the 2007 to 2012 period.

Since most funds target gross annualized returns in the mid to high teens, 12% net-of-fees and pre-tax seems like a reasonable expected return in USD. But is it?

Low Correlation Through Listed Equities

Virtually all proponents of real estate alternatives will at some point highlight the uncorrelated nature of direct real estate investments. And this is true. In order to calculate correlations, one requires a data set, and since private real estate doesn't provide mark-to-market data, it's uncorrelated! We can, however, compare total returns but adjusting for risk is nearly impossible – and this is true in Sao Paulo and San Francisco and South Park.

To address this, Tierra Analytics devised a unique weighting methodology which results suggest that listed real estate equities can be weighted such that correlation and beta are minimized relative to major benchmarks. Furthermore, our methodology suggests that real estate equities in the region may produce very significant alpha – and comparable total returns to the top-tier direct investments. While we can't analyze direct investments on a risk-adjusted basis, we can demonstrate that direct investments should at least beat our index on a total return basis. And on this point, most direct investments likely fail to outperform. The problem, therefore, is that direct investments appear to be very expensive, significantly overvalued relative to our index and very illiquid.

Since we began tracking the Latin America Real Estate Index (LARE), the model returned a whopping 219% for the period 2007 through 2012 (versus 26% for the NCREIF, -3% for the S&P 500 and 19% for the ILF). Moreover, the LARE is only 27% correlated to the S&P 500 and 63% correlated to the ILF. LARE's beta relative to the S&P 500 was 0.78x whereas the ILF was 1.38x. On a risk-adjusted basis, the LARE returned 39% annualized alpha versus 0% for the S&P 500 and 4.2% for the ILF. Finally, the LARE was only 61% correlated to the Brazilian FX whereas the ILF was 88% and the S&P 500 was 37%.

The growing interest in core strategies in the region will make benchmarking with the public markets even more plausible since core returns generally rely upon current yield.

Why the Excess Returns?

For starters, we believe our methodology captures what already happens in the marketplace but is not reflected in every company's market cap. Furthermore, we believe that the daily price changes of most equities in the region are highly correlated and consequently, there is little differentiating between overall performance – unless an investor addresses the weighting methodology. Finally, someone benefits from these excess returns and we believe it is generally not the typical public investor.

Private real estate investors give up big fees to management as well as incalculable opportunity cost resulting from the manager's subjective nature of investing. How does an LP know if the manager really reviewed the best deals in a market or didn't invest in some of the worst? Direct investing lacks diversification since there are relatively few funds that operate in the region and generally invest with the same operating partners. Lastly, there are also structural issues that act as a cap on total demand for private equity, which serve to drive down the value of the LP's capital.

Private equity, unlike an operating business, does not maintain land reserves and lacks the infrastructure and human capital necessary to exploit early opportunities. Granted, in down markets, this may be viewed as an asset but as our study shows, public companies wildly outperformed the broader benchmarks.

We have to ask, then, are direct investors not simply late-stage sources of cheap growth capital or reluctant middle market investors in operating companies who tend to pay a premium for access to deal flow?

Private real estate investors give up big fees to management as well as incalculable opportunity cost resulting from the manager's subjective nature of investing.

On the public side, markets remain fairly closed for small and mid-size companies. Large-cap public companies have ample access to the public markets but that's not the case for an emerging privately held mid-cap. The same can be said for large private real estate investors. They bring not only large piles of dry powder but also access to the debt capital markets and that leverage, in large part, is why they are able to drive returns. Our approach to weighting, in our opinion, captures most of these forces at play in the public markets.

As was the case with the US real estate markets in the 1970s before the explosion of REITs, most investors could only gain exposure to real estate through private vehicles. The emergence of the REIT industry changed all of that – as is beginning to happen in Latin America. The logical next step for the institutional investor is to explore alternatives that use listed equities as a means to gaining exposure. Whether this is in the form of open ended funds, ETFs or separate accounts remains to be seen but the data is convincing that the industry needs to evolve.

In short, unless a private real estate manager returned more than a 40% annualized return over the 2007 to 2012 period, net of fees, they likely underperformed. We believe the industry typically returns about half or less over time, net of fees, and the stellar returns realized just prior to the global recession are unlikely to materialize any time soon. The question is why would investors sacrifice liquidity for severe underperformance?

Author Biography

James is a real estate private equity advisor focused on the Americas region. Since 2008 he has advised on $1.75 billion of exposure in Brazil and Mexico on behalf of pension investors. Additionally, Tierra manages a long/short equity fund. Our strategy takes a bottom-up approach to individual companies within the current macro environment. We are currently outperforming the S&P500 on a 1, 3 and 5yr basis. Mr. Anderson can be reached at james.anderson@tierra-partners.com and resides in NYC.

China and Latin America: A New Normal?

Bernard Lapointe

For most of the last decade Latin America had the good fortune that its economic performance has been closely linked to that of the Chinese economy, the world's main growth engine. The Asian giant's contribution to global growth has risen from 0.25% in 1998 to almost 0.8% currently, while its nominal GDP quadrupled. The past decade has also seen the largest infrastructure construction program in world history, with the nation's total length of highways increasing by 133%, installed power capacity tripling and some 4.9 billion square meters in residential floor space completed.

Source: HSBC

China's insatiable demand for all sorts of commodities, from industrial metals to energy and soybeans, has benefited Latin America in at least 2 ways: rising prices and export volumes have resulted in large current account surplus; and foreign direct investment has risen in order to exploit the region's vast natural resources.

It is not a surprise that the countries that posted the best performance throughout the last decade are also the ones with the closest commercial ties with China, namely Argentina, Brazil, Chile and Peru. On the other hand, Mexico has suffered from the Asian giant's competition in the manufacturing sector.

But What Next for Latin America?

In the 12th five-year plan announced by the Chinese government in 2011, it was clearly emphasized that the country would be moving from an economy driven by 'quantity' to one driven by 'quality.' After 20 years of double-digit GDP growth, China has entered into a period of slower growth, say 7-8% per annum in real terms. The transition from investment-led growth to consumption-led growth implies that China's demand for industrial metals and energy is unlikely to post significant gains from current levels, sapping demand for Brazil's iron ore, Chile's copper and Colombia's oil.

Bilateral trade between China and Latin America grew at 30% annually between 2001 and 2011. In 2011 Latin America represented 14% of total Chinese exports. After surging more than 18-fold between 2003 and 2011, Brazil exports to China, however, have recently collapsed. As a result of the increase in China's demand for commodities, Chile and Brazil exports to China now account for a bigger share of their GDP than their exports to the US.

China's move away from commodity-dependent investment will dampen economic growth in Latin America unless countries in the region can either depreciate their currencies or raise productivity. Commodities exports account for half of the region's exports. It is doubtful that Latin American countries can depreciate their currencies in a world where major central banks are on track to continue their expansionary monetary policies. If restoring competitiveness through exchange rate depreciation is not possible, then there is no choice but to raise productivity through reforms. The only realistic alternatives governments have are to boost reforms in labor markets, taxation, energy, infrastructure and education.

The good news for Latin America though is that China will continue to invest a large amount of capital in the region. China invested a total of nearly US$12 billion in Latin America in 2011, up from $7.3 billion in 2009. This can in part be attributed to the fast development of China-Latin America cooperation. The rise of China in Latin America, long considered the United States' "backyard," took many by surprise. Now, its economic influence in the region is only expected to grow. In fact, China replaced the United States as the top trading partner in Brazil and Chile and is on its way to doing the same in many others countries in Latin America.

The first massive wave of Chinese investment in the region, begun in the early 2000s, was to guarantee access to raw materials, like land for soybeans and iron ore plants. In this current second wave, Chinese companies are keen to explore the region's consumer markets. Hence car makers Chery and JAC plan to build automobiles in South America destined for the local markets.

Closer economic links have made politics more fluid. Indeed, many leaders are keen on maintaining the status quo. In 2012, China's top 3 leaders, Hu Jintao, Wen Jiabao and Jia Qinlin, all visited the region. In the summer of 2012, China's Foreign Minister Yang Jiechi held talks with his counterparts in Cuba, Venezuela and Chile to discuss the possible formation of a forum between China and Latin America, similar to the high-profile and highly successful China-Africa Forum.

Economic and political relations between China and Latin America are likely to continue expanding over the next decade, albeit at a slower pace than what we have become accustomed to in the past 10 years. China's economy is heading towards a 'new normal,' which is very different from the 'old normal' boom years of 2003-2011.

	Exports to China/ GDP In 2000	Exports to China/ GDP In 2011	Exports to USA/ GDP In 2011	Exports to EU/ GDP In 2011
Brazil	0.2%	1.8%	1.0%	2.1%
Chile	1.2%	7.5%	3.6%	5.8%

Source: Thomson Reuters Datastream

AUTHOR BIOGRAPHY

Bernard Lapointe is a Portfolio Manager in the Overlay Strategies division at Caisse de dépôt et placement du Québec, a Canadian-based global fund manager. Mr. Lapointe has been a portfolio manager and trader of equities, currencies and commodities since 1994. He holds a Master degree in Economics and speaks French and Mandarin.

Winning by Failing
The New Entrepreneurial Paradigm Shift

Tom Kadala

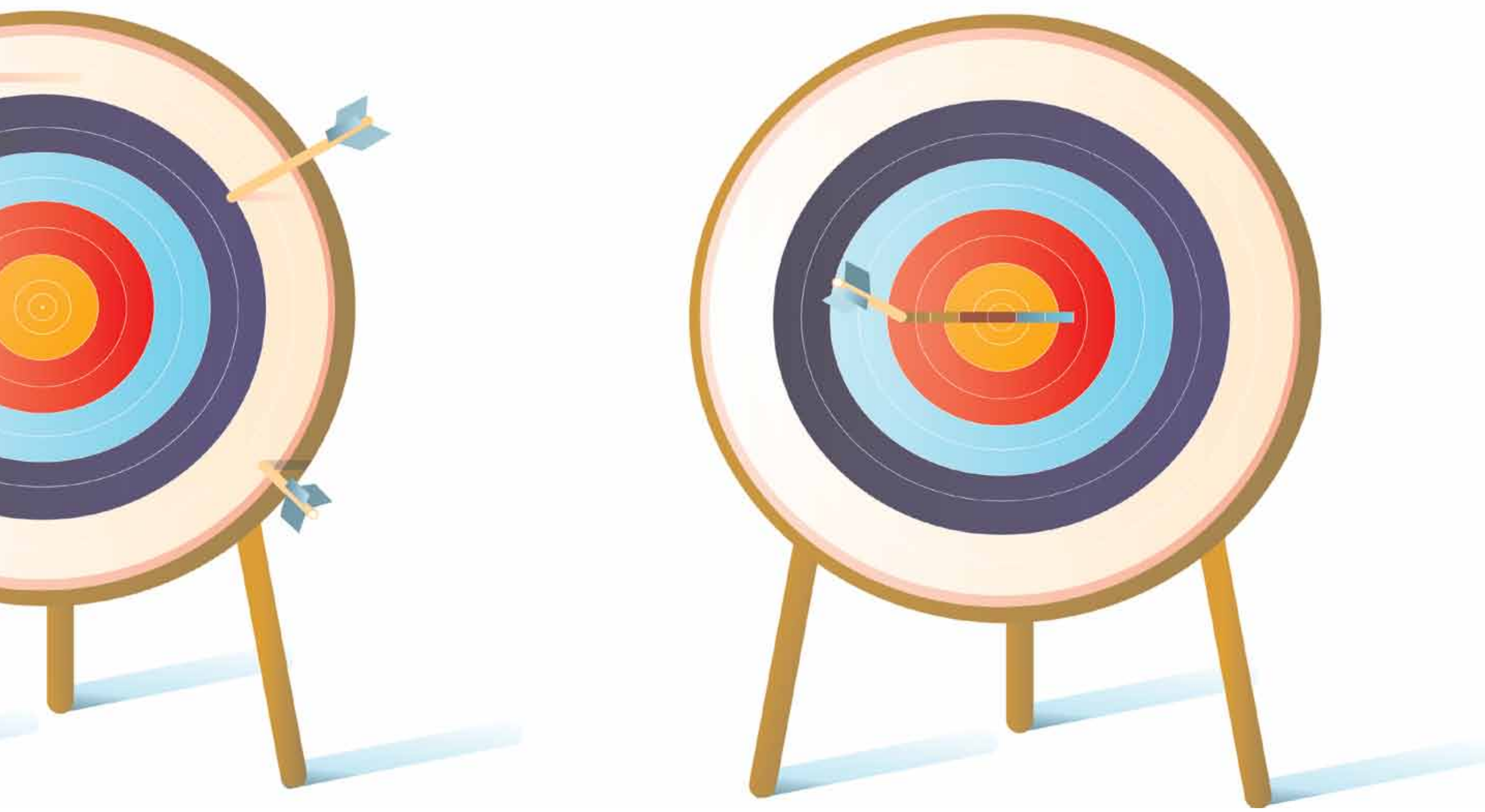
Why is it that startup companies that fail never make headline news? A likely reason is that few readers are interested, and yet, over one-half of new startups fail during their first year of operations. To make matters worse, their unfortunate founders are often subjected to heavy losses, fines, foreclosures and humiliation, just for trying to fulfill their dreams. Why then, do societies worldwide come down so hard on these well-intended individuals, especially when they represent a potential source for job creation? Are entrepreneurs who fail outcasts or overlooked assets?

Successful startups or inventions do not just surface out of thin air. Thomas Edison, one of the greatest inventors of modern times, once claimed that he never invented the lightbulb but rather confirmed 2,000 ways of how not to make a lightbulb. Edison knew that his inventions hinged on repeated experiments, the vast majority of which would fail. Why then did he consider his failed attempts more valuable than his inventions? Was it because he viewed his successes and breakthroughs as an afterthought? In a new world order where inventors have had to become entrepreneurs and entrepreneurs inventors, could Edison's approach to 'inventing/winning by failing' offer us some new insights?

Imagine if...

Imagine if, instead of shunning entrepreneurs who failed, societies embraced their expertise (such as the many ways not to make something work) by efficiently reintegrating their experiences/experiments into an ongoing process of discovery and invention? Take this idea one step further. Imagine if, these entrepreneurs were motivated to work together by co-owning shares of an organization that was partially funded by the profits of the companies whose ideas/inventions did succeed.

While most entrepreneurs would support this type of arrangement, the traditional establishment of venture capitalists, private equity investors, politicians and large established companies may not. But, as technology advancements continue to enable entrepreneurs to accomplish more with lower funding requirements, investors and their cohorts may, at some point, be wise to reconsider their old business models.



Evidence of Edison: A 5 Country Review

To see, if indeed, entrepreneurship is trending toward an inventor's model, I met with key leaders from 5 different countries including an academic institution, (Ecuador, Chile, Kenya, Mexico, and MIT) and compared their respective entrepreneurial initiatives. My choice of countries coincided with a slew of conferences and meetings that I attended between the months of August and September of 2012.

With each person I met, I inquired what policies, if any, they or their respective governments/institutions were actively pursuing to promote local entrepreneurship. If they were entrepreneurs, I asked about their experiences and expectations. Over time their collective comments developed into an interesting mosaic, which reflected their wide range of experiences promoting entrepreneurship. Less experienced countries sought lofty goals and often highlighted successful models elsewhere. Assuming this trend, one might conclude that the country/institution with the most experience could thus be considered the industry trendsetter.

Least Experienced - Ecuador, Chile, Kenya

Countries with the least experience promoting entrepreneurship such as Ecuador are usually held back by their own overburdening bureaucracy and an economy largely operated by a handful of family-owned businesses. Chile partially addressed these issues by legislating laws that designated a protected area (legally and physically) for its new startups. Their plan also included shared support systems (i.e. office space, Internet connection, etc.), and funding for an aggressive international mentorship program. Kenya's government built out an Internet infrastructure that today connects over 40 million Kenyan users. They also approved the use of a mobile phone digital currency called M-Pesa that together has mobilized local entrepreneurs and investors.

Midway - Mexico

At midway, Mexican thought-leaders are grappling with more sophisticated issues such as integrating venture capital funding. Key to their strategy is a coordinated effort among Mexican government officials, local venture funds and public universities (i.e. Tecnológico de Monterrey) to identify the next 'Steve Jobs-like' entrepreneurs (or, in their words, 'super entrepreneurs') who are capable of building the next 'Apple-like' industry on Mexican soil. To attract greater investor interest, the Mexican government recently approved a US$120 million 'fund of funds' to encourage more venture fund managers to work with their most promising startups.

Most Experienced - MIT Media Labs

The highest level of experience, also tagged as the industry's potential trendsetter, in my sample was MIT's Media Lab (Massachusetts Institute of Technology). Under the direction of Joicho Ito, an accomplished investor and colorful visionary, MIT's Media Lab operates about 350 concurrent student-related startups. Ito explains that his primary focus is to develop a team's collective agility rather than the prowess of one exceptional individual. Startup founders find each other, are free to innovate together as they see fit, and, when ready, present their ideas for funding by conducting a proof-of-concept such as a small pilot or survey. Funding is limited to no more than $100,000 per team. Teams that succeed may pitch for more funding (with a formal business plan), while those that fail are encouraged to join another team.

Future entrepreneurial programs would do better if they focused more on efficiently recycling lessons from failed attempts than on sifting through haystacks of candidates in search of a few needles of success.

Teams are expected to conduct many small pilots and leverage their data analytics to identify timely opportunities. Ito's unwritten rule of denying a second round of financing has forced team members to become more agile with their decisions. As expected, however, failures do happen and are not only common at the Media Lab, but most importantly, revered. According to Ito, students who learn to fail several times actually win by learning the art of risk taking. Given several chances to take risks within a short period of time has proven to render more 'breakthrough ideas' as well as develop a more seasoned crop of team leaders/entrepreneurs.

Conclusion

This brief 5-country evaluation simplifies the entrepreneurial process into 3 distinct levels and suggests that sequential levels place the most experienced country/institution as the potential trendsetter, in this case MIT's Media Labs.

Assuming my analysis is true and MIT's Media Lab succeeds at creating companies responsible for new industries in the coming years, then one might guess what advice Thomas Edison would have given to governments and institutions if he were alive today. According to Edison, future entrepreneurial programs would do better if they focused more on efficiently recycling lessons from failed attempts than on sifting through haystacks of candidates in search of a few needles of success. Hopefully Edison's likely advice will turn on a few more lightbulbs in the minds of our global leaders!

Appendix

I have included an Appendix for those of you interested in more details and interesting tidbits from my interviews with each country/institution for this article.

Guayaquil, Ecuador

Considered a hidden city by investors in-the-know, Guayaquil recently conducted a national roadshow, http://www.nationroadshow.com/guayaquil/en, that began in New York City. In my brief interview with their mayor, Jaime Nebot, he expressed his views on entrepreneurship for his city in 2 words: “Not now!” Ecuador, like other Latin American countries, is controlled by a handful of influential family groups who operate the country’s key businesses. For young Ecuadorian entrepreneurs, the chance of succeeding is both intimidating and inhibiting, not to mention the 8-month lead time needed just to register a company and fulfill all of the public-sector requirements. Venture funding exists primarily for launching new businesses within already established ones. Most new businesses are proven concepts transferred from other countries rather than breakthrough technologies that could offer spectacular returns. For now, Mayor Nebot is focused on attracting established international firms to Guayaquil that have the wherewithal to weather his country’s stifling bureaucracy.

Santiago, Chile

At a recent conference on M&A activities in Latin America held at the offices of Baker & McKenzie - (www.bakermckenzie.com) in New York, a cadre of legal experts described Chile’s financial economy as brisk. Unlike Ecuador with its family-owned monopolies, Chile’s formerly family-owned firms have been institutionalized and therefore easier to merge and acquire. Despite these advances, entrepreneurialism in Chile has had its challenges. Young Chilean students who might have taken to entrepreneurialism sooner prefer careers in finance, medicine or law. About 2 years ago, the government of Chile approved funds for a revolutionary program called Startup Chile (www.startupchile.org). Hoping to change the mindset of its youth, Chile’s government is offering entrepreneurs from around the world a US$40,000 grant to spend 6 months launching their startups in one of two buildings located in downtown Santiago. The program attracted seasoned global entrepreneurs who served as mentors to Chile’s young hopefuls. Chilean entrepreneurs today account for over half of the startups in the program. One of the participants I interviewed at a local meeting in New York described the environment at the incubator in Santiago as serious-yet-fun, inspiring, rewarding and very international. Founders often work with one partner on premise and form virtual teams-on-demand using shared referred resources sometimes located in other countries.

Hoping to change the mindset of its youth, Chile’s government is offering entrepreneurs from around the world a US$40,000 grant to spend 6 months launching their startups in one of two buildings located in downtown Santiago.

Nairobi, Kenya

A banking phenomena called the M-Pesa has emerged in the unlikely city of Nairobi, Kenya. M-Pesa is a cell phone currency operated by Safaricom (www.safaricom.co.ke) that has transformed local economies in a manner that few could have imagined possible and that other countries have had difficulty emulating. Similar to PayPal’s online capabilities (www.paypal.com), M-Pesa funds appear as a balance on a cell phone account that can be drawn and transferred at the time of purchase from one cell phone to another. Its resounding success has created fertile ground for Kenyan entrepreneurs and has attracted investor groups including a local bank. As expected, Kenyan entrepreneurs have formed their own version of an incubator/consulting operation called iHub, (www.ihub.co.ke) where local techies and investors can congregate. Despite having many fundamental issues to resolve, Kenya’s success in lubricating its economy with a digitized currency is truly noteworthy. Credit is largely due to the Kenyan government who played a crucial role in building out the infrastructure needed to connect over 40 million cell/Internet users.

Mexico City, Mexico

At a recent conference held in New York by the Mexican-American Chamber of Commerce - Northeast Chapter, (www.usmcocne.org on Mexican innovation, entrepreneurship and venture capital financing, 2 panels of key influencers shared their views. There I learned that 99.8% of the firms in Mexico produce just over half of the country’s annual GDP (52%). Most revealing was that the remaining 0.2% of Mexican firms are in the hands of the ‘super-rich’ who collectively account for the other half of the country’s annual GDP. With half of the country’s GDP in so few hands, venture capitalists and similar funding sources have seized the opportunity to disrupt the status quo with a new crop of technology-based firms that could deliver 'Apple-like' growth and a similar ecosystem of supporting companies. Their plan of attack as expressed at the conference was principally focused on identifying 'Steve Job-like' candidates who would agree to work tirelessly, communicate effectively, innovate constantly and function amenably with their venture capital support teams. They referred to these individuals as 'super entrepreneurs.' To fill the pipeline with potential candidates, one of Mexico's largest academic institutions, Tecnológico de Monterrey, operates a Technology Center for Entrepreneurs (www.itesm.mx). The center currently manages a total of 1,500 startups per year. Startups that show exceptional promise graduate to the university's accelerator program and may eventually compete for venture capital funding. This step also includes assistance from internationally recognized nonprofit organizations such as Endeavor Global (www.endeavor.org), also present at the conference. Graduates from the exclusive Endeavor Global program work with leader/mentors along with their peers to gain additional market access and intel. Mexico's Venture Capital (VC) industry is small in comparison to the US but is making meaningful strides. They have approved legislation granting VCs with limited access to its hefty pensions. In addition, the government has recently approved a $120 million fund called the Entrepreneur's Fund or 'fund of funds' to encourage more local money managers to address the needs of their up-and-coming squadron of 'super entrepreneurs.' The government's support is crucial and timely for Mexico, since its crop of qualified candidates are more global in scope than their predecessors and could easily decide to move their businesses to another country for support and funding.

Cambridge, Mass. (MIT)

At MIT's student incubator known as the Media Lab in Cambridge, Mass., (www.media.mit.edu), Joicho Ito, an accomplished investor and colorful visionary, oversees over 350 concurrent student-related startups. On the surface, the incubator program appeared similar to the incubator/accelerator initiative at the Tecnológico de Monterrey in Mexico. However, a closer inspection showed that their similarities ended at the front door. At the Tecnológico de Monterrey, startup instruction is centered around the rigors of writing and rewriting a comprehensive business plan that might, one day, be used for funding consideration at a venture capital firm. In contrast, MIT's Media Lab postpones the business plan writing exercises until funding has been approved. Heretical in his approach, Ito explains that his primary focus is a team's collective agility rather than the prowess of one exceptional individual or a business plan subjected to the rigidity of an outline and presentation. Startup founders find each other, are free to innovate together as they see fit, and, when ready, present their ideas for funding by conducting some form of proof-of-concept such as a small pilot or survey. Funding is limited to no more than $100,000 per team. Teams that succeed may pitch for more funding (with a formal business plan), while those that fail are encouraged to join another team. Teams are expected to conduct many small pilots and leverage their data analytics to identify timely opportunities. Ito's unwritten rule of denying a second round of financing has forced team members to become more agile with their decisions. As expected, however, failures do happen and are not only common at the Media Lab, but most importantly, revered. According to Ito, students who learn to fail several times, actually win by learning the art of risk taking. Given several chances to take risks within a short period of time has proven to render more breakthrough ideas as well as develop a more seasoned crop of team leaders/entrepreneurs.

Author Biography

Mr. Kadala is an internationally recognized writer, speaker, and facilitator on topics that concern CEO's and political leaders. He is well-versed in economics, engineering, technology, finance, and marketing. His views are regularly published by prominent industry publications and also distributed to an exclusive list of contacts, most of whom he has met personally during his 20+ year tenure as the founder & CEO of Alternative Technology Corporation (ATC, Inc.). He earned a Bachelor in Science in Civil & Environmental Engineering from Cornell University and an MBA with a concentration in Finance from the Harvard Business School.

Mr. Kadala's ability to communicate complex issues to a wide range of audiences in writing or in person (English or Spanish) has won him a favorable reputation among his peers as someone who is "not afraid to tackle tough global issues". Most recently, Mr. Kadala developed a facilitated discussion format called Business Model Innovations or BMI's that was implemented successfully at the United Nations on renewable energy investments strategies for developing counties. For more details on the BMI process, please visit www.ResearchPAYS.net

New IPOs and Fibras Listings Expected on the BMV in 2013

Adriana Curiel and Vanessa Buendia in Mexico City

Mexico's stock exchange could have a trend of new listings of Fibras (the Spanish acronym for real estate investment trusts) in 2013 following Macquarie's listing and an acquisition announcement by Fibra UNO in 2012, industry sources said.

According to two industry sources and a financial analyst, Interjet and Fibra Finn (Asesor de Activos Prisma) are some of the companies that could launch an IPO or Fibra listing this year.

The analyst noted that Bolsa Mexicana de Valores (BMV), the Mexican Stock Exchange, had a record number of IPO listings in 2012 totaling USD 9 billion. Listings in 2013 are expected to exceed that amount, the analyst added.

The first industry source said Interjet has decided to wait until political issues "calmed down" and the new government, helmed by President Enrique Peña Nieto, began its tenure on 1 December. More IPOs will follow the Interjet IPO, he said. The analyst also mentioned that the PepsiCo bottling company Geupec, which recently changed its name to Grupo Cultiba, will launch an IPO during 1Q13.
Market rumors have also circulated that Grupo Alfa (ALFA) could look to launch IPOs for its subsidiaries Nemak and Sigma, as it did with Alpek (ALPEK) this year.

The first industry source considers the delisting of companies in 2012 as a good sign of renewal for the BMV, because there were companies that should not have been listed due to their low activity or the fact they went through a corporate restructuring. Among the companies that delisted in 2012 are Grupo Azucarero Mexico (GAM), Carso Infraestructura y Construcción (CICSA), Grupo Martí (Gmarti), and Telefonos de México (Telmex).

Meanwhile, the BMV is expecting 5 or 6 more Fibras listings in 2013, according to local press reports citing Luis Tellez, President of the BMV. When asked about which companies could be on this list, the industry sources declined to speculate, but recalled that Fibra FINN has expressed interest.

Macquarie Group's Mexican REIT raised around USD 1.15 billion earlier this month, including over-allotments. After the launch, Macquarie announced that it would acquire an initial portfolio of 244 industrial properties spread across 21 cities in 15 Mexican states.

On 13 December, Fibra UNO announced that it requested its shareholders to approve an investment of around MXP 18.4 billion (USD 1.4 billion) to acquire 30 industrial properties that will more than double the area of its portfolio to around 3.5m square meters. According to a BMV announcement by Fibra UNO, the company expects to finance 46% of the investment with a follow-on share offer.

According to the first industry source, Mexico's hotel industry could recover next year given the entrance of the new federal government. Fibra Hotelera Mexicana (FIHO) is expected to continue growing via acquisitions in the country, particularly in Cancun and the Yucatan peninsula. As previously reported, FIHO is expected to use the lion's share of the USD 318 million it raised in the securities sale to acquire 12 hotels from Grupo Posadas.

In April 2011, this news service reported that Grupo Frisa was interested in hearing from advisors to know more about this option. Frisa operates 37 shopping centers in the country with some 300 employees.

mergermarket

Company Biography

Mergermarket is the leading provider of forward-looking M&A intelligence and data for M&A professionals and corporates. With an unrivaled network of 300-plus journalists based in 65 locations worldwide, mergermarket is the only tool that offers active intelligence on corporate strategy before it becomes public knowledge, and historical data to analyze past deals. Mergermarket is part of The Mergermarket Group, a Financial Times Group company. Visit www.mergermarket.com.

Private Equity in Brazil

The Music Hasn't Stopped

Camila Aguirre, Oscar Lauz del Rosario, Ryan Meehan and Rodrigo Patiño

According to data provided by the Emerging Markets Private Equity Association (EMPEA), Brazil's PE industry in 2011 raised a record US$7.1 billion, or 18% of the new capital committed to emerging markets. Of this total, it invested US$2.5 billion across 47 companies. More than half the deals were in the energy, infrastructure and consumer sectors. This comes as no surprise, as Brazil has the largest consumer market in Latin America, worth US$1.5 trillion in 2011. The country is more open to PE than ever before, with success stories covered in the local press, stronger capital markets and an increasingly institutionalized investor base.

Brazil's Economic Takeoff

Over the past decade Brazil has exceeded expectations, becoming a success story among emerging market economies. Per capita GDP rose from US$2,812 in 2002 to US$12,594 in 2011, growing 18% a year on average. In September 2012, Brazil's unemployment rate was at a near record low of 5.4%, compared to 7.8% in the US.

The Brazilian economy's success has translated into increased consumer spending in a variety of areas, ranging from basic goods to furniture and automobile sales. In addition, the government continues to invest money in offshore oil exploration. The country is currently home to the second largest infrastructure project in the world — the development of its offshore oil deposits in the pré-sal, which will bring in US$270 billion in investments over the next 10 years and a huge demand for ancillary products and services. This project is expected to generate 2 million new jobs in an industry that currently has only 500,000 employees. Along the way, Brazil has attracted significant foreign capital, as investors seek to capitalize on the country's growing consumer segment and infrastructure needs.

Despite Brazil's relatively slow growth in the economy over the last 2 years, the consumer sector continues to see double-digit growth in the lower middle class. Given the country's tumultuous history of government intervention, corruption and a bout of hyperinflation in the not-too-distant past, one must consider how the different administrations were involved with the marketplace and to what extent they have been responsible for Brazil's current status.

Most people agree that the foundations for the consumer sector's success were established during President Fernando Henrique Cardoso's administration. The economic stability resulting from the Plano real of 1994, which consisted of a series of contractionary fiscal and monetary policies and the creation of a new currency, dramatically reduced the levels of inflation inherited from the post-military dictatorship, allowing consumers to save and purchase on credit. Inflation is corrosive to society and severely affects the purchasing power of the lower class, which is heavily affected by increases in staple goods and which possesses limited assets. Once inflation was controlled, it became possible to invest in the growth of the emerging Brazilian consumer.

The administration of President Luis Inácio Lula da Silva, from 2003 to 2010, although initially feared by the marketplace for its radical rhetoric, was able to gain the trust of the private sector by maintaining market-friendly policies. Over the same period, Brazil managed to increase its middle class from 26 million to more than 59 million, aided by social programs such as Bolsa Familia, which provided financial support to millions of underprivileged families throughout the country. New consumption patterns also developed, making Brazil one of the most coveted emerging markets.

Under the leadership of President Dilma Rousseff, investors are eager to see what new policies will be enacted. Although one should not expect major changes, due to the affinity between Lula and Rousseff, the current administration is under pressure to continue its predecessors' consumer growth. During the last 12 months, the SELIC target rate has shown a substantial decrease from 11.0% to 7.25%. Analysts expect that Rousseff will offer cheaper lines of credit to the lower-middle class, often referred to as "class C," a group that has long depended on credit provided by retailers. Euromonitor International research indicates that Brazil's annual lending rate averages 43.9%, compared to 14.1% in Argentina, 12.4% in Indonesia, 10.4% in India and 6.6% in China. Government support for consumer financing can be seen in the recent interest rate cuts at Banco do Brasil and Caixa, the 2 largest state-owned banks in Brazil, and the extension of credit to less affluent individuals. Despite substantial government pressure on banks to reduce their lending rates, there is anecdotal evidence that some private banks are pushing back. Recent media reports estimate loan growth of 10% in 2012, down from the previous estimate of 14% to 17%. This may be a signal from the banks that management is trying to reduce future exposure to bad loans by avoiding higher-risk loans, or that the demand for loans remains lackluster. As of February 2012, 44% of the total credit in the financial system came from the public financial system, compared to only 34% in February 2008. Such trends are being observed keenly by investors interested in the region, as they plan their next moves in the consumer retail sector.

Private Equity, Brazilian Style

Over the past decade, the Brazilian PE sector has grown significantly, deploying over US$22 billion of capital. Brazilian PE funds have played an important role in the economy, helping to professionalize family-owned businesses, improve corporate governance and provide needed growth capital. According to a 2011 Knowledge@Wharton report on the Brazilian PE market, nearly one-third of the companies listed on BOVESPA between 2004 and 2008 were PE-backed, helping to promote the development of the country's capital markets.

In 2011, Brazilian-focused funds raised a record US$7.1 billion, significantly above the 2008 peak of US$3.6 billion. Fundraising is concentrated, with the majority of capital invested with 4 firms: Gávea Investimentos, BTG Pactual, Vinci Capital and Patría Investimentos. As of September 2012, fundraising activity had slowed down, with only US$1.7 billion raised for the year so far. Recent fundraising shows an increased focus on the infrastructure and energy sectors, with US$1.4 billion raised for specialized funds from BTG Pactual, Mantiq Investimentos and Valora, among others.

Investment activity has accelerated, with US$3.4 billion invested in the first 3 quarters of 2012 compared to US$2.5 billion the previous year. In an interview with EMPEA, Piero Minardi, a partner at Gávea Investimentos, recently noted that they had "already deployed almost half of the $1.9 billion fund" they raised in 2011. Anecdotally, although funds are aware of increased competition, several managers feel the sector is still underpenetrated, with 2011 deal flow representing less than 0.1% of GDP compared to 1.0% in the US and 0.3% in India.

PE strategies have evolved significantly in Brazil. With a history of high inflation, dollar-denominated funds, prohibitive hedging costs and limited exit opportunities, the 1990s and early 2000s saw investments in companies with an export-oriented business model, where revenues would be in foreign currencies. In light of limited exit opportunities, investors had to think about "exit first," ensuring that the asset had multiple natural buyers. Minardi pointed out that

following the 1999 currency devaluation, "weak capital markets remained a big concern. ... It was tough to go in front of an investment committee and say you felt secure in having an exit."

Interviews with local PE managers and consultants revealed 3 areas of focus for investment today: infrastructure, retail and health care. Chris Meyn, a partner at Gávea Investimentos, noted that "inadequate infrastructure and education are the main constraints to Brazil's growth today. The country has high electricity and logistics costs. Only 10% of roads are paved, and the country faces increased infrastructure needs from industry and growing sectors, such as offshore oil." While some investors are attracted to the stable cash-flow base, a GP Investimentos representative commented that infrastructure and commodity deals often face lower target returns; they prefer "deals that give us exposure to the domestic Brazil" and are less dependent on what happens in China.

The other areas of focus — retail and health care — are targeted largely due to the attractive growth of the Brazilian consumer base. Retail sales are expected to grow from US$289 billion in 2007 to US$550 billion in 2012 (13.7% CAGR), and the health care segment is struggling to meet demand, with a tenfold increase in public health care expenditures since the government established the United Healthcare System in 1988. A Credit Suisse report highlighted that working-age adults (18-65) represent nearly two-thirds of the population, and the country's demographic dividend is not expected to peak until between 2020 and 2025. Low unemployment, wage growth and expansion of credit will continue to drive the development of the middle class.

Patría Investimentos' investment in Alliar, a medical imaging company, and Carlyle's acquisition of Tok Stok, a furniture retailer, illustrate the continued interest in the rise of Brazil's middle class. According to data compiled by Bloomberg, 34 of 80 PE deals announced in 2011 were consumer-related. Fernando Borges, head of Carlyle's South American Buyout team, explained that their "focus will keep being companies related to consumption, rising income and the growing middle class."

Most of the Brazilian stock market remains tied to extractive industries. But there is still a large unmet demand from international investors to gain access to companies in the consumer sector that are better tied to Brazil's macroeconomic fundamentals. Consequently, PE funds continue to see consumer deals as a priority area for them in Brazil. These deals will allow investors to build companies that will have a natural and attractive exit potential through an IPO.

The positive environment for the consumer sector has brought significant additional competition in the form of new local PE firms, foreign investment groups and strategic acquirers who have greater confidence in the Brazil risk (Brazil has been investment-grade since 2008 and is now considered "BBB" by the major rating agencies). A GP Investimentos representative recognized that the fund had actively looked at a number of deals in the consumer space but decided not to move forward due to valuation expectations. Funds have to rely increasingly on their proprietary networks to source their transactions.

A fund manager, who asked to remain anonymous, commented that one of the most significant problems with Brazil today is not leverage per se, but rather the high interest rates and low durations of consumer loans. An increase in duration and a decrease in interest rates could easily see a doubling of the consumption power of the middle class. Bloomberg noted that in 2012, Rousseff had already taken multiple steps favoring consumption growth, such as cutting taxes on durable goods and pressuring banks to cut interest rates on credit cards.

The technology and e-commerce sectors have seen more interest from VC funds such as Redpoint e.Venture and Monashees, which have invested in online retailers such as baby.com.br and Sophia & Juliette. Industry experts predict Internet penetration will increase dramatically in the nation, and they forecast e-commerce growth of more than 30% per year. Most recently, there has been a flood of "tropicalization," the business of replicating online startups that have already succeeded in other markets. Examples include Peixe Urbano, a Groupon clone, and baby.com.br. Given the success of such ventures, it is likely that e-commerce will continue to attract significant investment from PE and VC backers.

In discussing the future of PE in the region, fund managers were lukewarm about Brazil's potential to serve as a platform for pan-Latin American investments. Gávea Investimentos' representative stated that it was important to stick to the fund's strengths; there are still too many opportunities at home. Minardi noted that "many of us are still very busy looking at the south region of Brazil, which is perhaps another indicator that Brazil is not yet overheated. People do not have enough time to go to other regions and look around because there is so much to be done locally." The GP Investimentos representative commented that acquiring or partnering with a foreign company could be attractive, but "it is difficult because the differences in culture are quite large." Family owners in Latin America are quite risk-averse and remember the deals where "a local investor from their country got burned investing in Brazil."

Is Brazil Too Hot?

There are many challenges associated with the recent influx of foreign capital into the Brazilian market. As competition has increased among funds, the prices that companies are willing to pay have surged. The GP Investimentos representative stated that foreign players are now more willing to pay very high prices for such assets. In August 2012, General Mills closed the acquisition of Yoki Alimentos for approximately 20 times the last 12 months' EBITDA. According to the GP Investimentos representative, investments from foreign markets allow local companies to take on debt and grow at much greater rates than they could on domestic credit lines alone. Such was the case with the 2012 sale of Fogo do Chão, a Brazilian steakhouse restaurant chain purchased by Boston-based Thomas H. Lee Partners.

The lack of infrastructure remains a primary concern among investors looking to develop businesses in the region, and could pose a potential risk to long-term projects that will require complex logistical operations. This has made infrastructure investment interesting to many PE funds. As mentioned by a PE specialist at Bain Consulting, there is great interest in the steady returns that can be made from energy projects, such as power plants and green energy. Some PE firms, such as Gávea Investimentos, have tackled these obstacles by investing in and building their own infrastructure for portfolio companies.

In 2010, Cosan SA Industria sold a US$226 million stake to PE investors Gávea Investimentos and TPG Capital. The partnership gave birth to a collaboration among business and private investors looking to solve the company's distribution problems. Together, they invested in a new rail system, replacing thousands of delivery trucks. In what could be an increasingly popular partnering, a company and its investors were able to tackle infrastructure challenges in an innovative and expedient way by circumventing government inefficiency. Yet, privately partnered infrastructure deals notwithstanding, investors will continue to ask themselves whether the government will be able to effectively meet the larger and more inhibitive infrastructure needs of the growing markets.

With the recent attention Brazil has received from foreign investment, many potential investors wonder if the economy is overheating due to increased competition and heightened attention on the upcoming World Cup and Olympic Games. Some are concerned about the country's ability to develop independently without a direct link to Chinese demand; others are worried about the potential "Dutch Disease" of a strengthening currency due to commodity exports and a rise in cost of domestic manufactured goods. With the recent slowdown of Chinese growth, the demand for soy and iron ore is on the decline, warranting worry.

Still others remain cautious about the government's ability to control inflation, estimated at 5.4% in 2012, above the government's goal of 4.5%. High inflation, combined with high interest rates, have many concerned about Brazil's consumer credit situation. This could prove to be a problem for consumer retailers and create unease for PE firms seeking to invest. Default rates on consumer loans reached 7.9% in August and were as high as 28% for credit card accounts at least 90 days overdue. While nearly 40 million Brazilians have entered the consumer middle class over the past 5 years, some investors, such as BlackRock's Will Landers, do not believe this is sustainable and feel that a more realistic outlook over the next 5 years is closer to 25 million — still a healthy growth rate, but not nearly as large a boost to the economy as in the recent past.

The positive news is that the Brazilian government has shown its resolve to lessen the burden on heavily indebted consumers by lowering interest rates, lengthening terms of payment and extending consumer-related tax breaks. The key factors for investors to weigh will continue to be government intervention and global demand. For now, the government seems committed to lowering the costs of doing business and increasing logistical capacity.

In August 2012, Brazil's government announced a US$66 billion stimulus blueprint to provide subsidized loans for improvements of road and rail systems. Plans to improve port and airport infrastructure are the country's next priority, although some state-run projects have already been planned, such as a nearly US$3.2 billion project at the port of Itaqui in the state of Maranhão. But investments will take time, money, proper management and oversight by government officials. Over the long term, as Brazil continues to grow steadily, the consumer retail sector will remain an attractive investment, but the path to high returns will depend ultimately on the Brazilian government's ability to manage resources, invest prudently and control consumer debt levels as domestic demand continues to grow.

Knowledge@Wharton

Author Biography

This article was written by Camila Aguirre, Oscar Lauz del Rosario, Ryan Meehan and Rodrigo Patiño, members of the Lauder Class of 2014 and republished with permission from Knowledge@Wharton http://knowledge.wharton.upenn.edu the online research and business analysis journal of the Wharton School of the University of Pennsylvania.

A decade ago, Colombia was struggling with political and social instability, a weak economy and widespread violence. With foreign direct investment (FDI) hovering around US$2 billion from 1999 until 2003, it was clear that the international financial community was not looking at the country as a favorable place in which to invest capital. However, with the election of President Álvaro Uribe in 2002, Colombia began to resolve the issues of violence and national security and lay the foundation for the economic boom experienced over the last 10 years.

The Private Equity Landscape in Colombia

Rodrigo Boscolo, Ben Shephard and Wallrick Williams

While in office, Uribe worked hard to change the international community›s negative perception of Colombia by dramatically reducing violence and attacking the country›s narco-trafficking problem. Where Colombia once led South and Central America in homicides per capita in 2002, recent United Nations (UN) statistics indicate a reduction of more than 50%. From an economic perspective, the country has also experienced explosive growth. Since 2002, Gross Domestic Product (GDP) has increased threefold, Gross National Income (GNI) has nearly tripled and FDI has grown sixfold.

At the same time, Colombia has also put in place the regulatory framework to help a formerly fledgling private equity (PE) industry become one of the most exciting industries in the region. According to Bancoldex Capital, 17 PE funds were raised in 2010, compared to only 2 funds just 5 years earlier. While challenges certainly lie ahead for the PE industry in Colombia, future prospects seem much brighter than they did just 10 years ago.

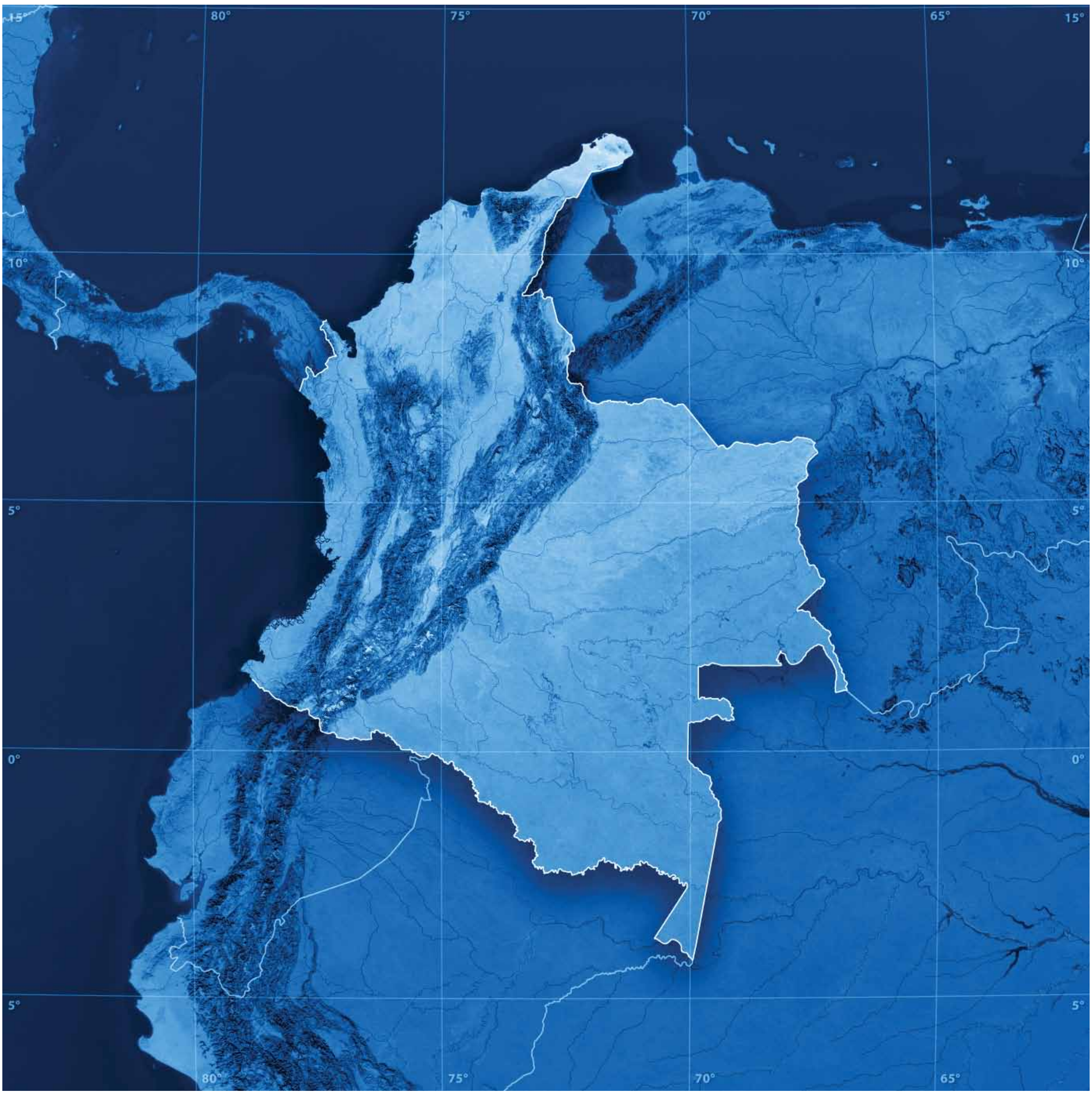
Colombia's First Private Equity Investment Cycle

Before Uribe's efforts to improve the country's economic and political stability, the PE industry was negligible in Colombia. As Hernán Cely of Advent International commented, «The period from 1997 through 2006 composed a lost decade for private equity in Colombia. International crises and domestic security issues hindered any private equity development.» Prior to 2005, there were no government regulations regarding the establishment of PE firms, the legal structures needed to form them or protections for minority shareholder interests required for structuring noncontrolling equity investments.

Passed in 2005, Decree 964, among other things, established minority shareholder rights and created a framework for transparency that specified appropriate board-member composition, required the formation of audit committees and mandated the timely disclosure of financial information, according to the Latin American Law & Business Report. These changes put corporate governance practices in Colombia on par with international standards, enhancing the country's credibility with investors and essentially made traditional PE investments possible.

Despite all this, only a handful of parties were contemplating PE investments in Colombia at this time, according to Euromoney — namely, local search funds, high-net-worth families and international players such as AIG, Darby, Newbridge Capital and The Carlyle Group. It is important to note that since 2006, 2 local PE firms, Tribeca Partners and Altra Investments, raised their respective first funds and attracted the attention of other regional PE firms, such as Southern Cross Latin America, Linzor Capital, Mesoamérica and SEAF, which have been very active. Despite the momentum in the PE market in Colombia at that time, only a few deals were closed and not many details were made public.

A key piece of legislation in 2007 marked a major milestone for the PE industry in Colombia. Decree 2175 legally defined PE firms (Fondos de Capital Privado or FCPs) as closed-end funds that are, according to Euromonitor, "(i) created for the purpose of raising and managing cash or other assets; (ii) composed of contributions by more than one investor, each with a contribution of at least $150,000; and (iii) composed of funds which are collectively managed and whose profits are distributed pro-rata among the contributors." More importantly, this decree allowed Colombian pension funds to invest up to 5% of their assets in local PE



funds. These changes signaled that the country was ready for PE investments and sparked a surge in the number of PE firms that were established. Between 2007 and 2010, more than 20 PE funds were raised compared to only 4 funds prior to 2007.

With new sources of funding, a well-developed regulatory framework, economic growth and mounting international attention, the Colombian PE industry has risen to a new level and is quickly becoming one of the most exciting markets in Latin America. In fact, according to the Latin American Venture Capital Association (LAVCA) scorecard, Colombia advanced from the 7th best country to invest in in 2007 to 4th in 2012.

Currently, more than 20 funds are operating in the Colombian market, including 5 with management from abroad, holding a total of US$2.2 billion in assets, according to Balcoldex Capital. The latest funds closed by local firms are much larger and now average US$200 million. At the end of 2010, Latin America Enterprise Fund Managers (LAEFM) closed its new Hydrocarbon Fund at US$350 million, and this year Altra Investments raised a new fund totaling US$164 million. According to LAVCA, 44% of the PE firms in Colombia are structuring new funds, and their combined fundraising targets could add as much as an additional US$2 billion to the market.

As these firms enter new fundraising cycles, local managers are starting to make good on their promises to seize opportunities and create value in Colombia through successful exits. In 2010, Tribeca made its first exit by selling Latco, an oil-drilling company, allowing its investors to realize an internal rate of return (IRR) of over 50%. Last year, Altra Investments made a highly visible and successful exit, showing a twofold profit from the sale of its stake in the Peruvian generic pharmaceutical company Corporación Infarmasa SA, which the fund had acquired in 2007.

While local fund managers seek to raise ever larger funds, pursuing not only local but also international funding, more international firms,

According to the Latin American Venture Capital Association scorecard, Colombia advanced from the 7th best country to invest in in 2007 to 4th in 2012.

including funds of funds, are dedicating additional resources to Colombia. In 2011, Advent, one of the world›s leading global buyout firms, opened an office in Bogotá. The Carlyle Group and Southern Cross, other bulge bracket funds, are also paying close attention to the country. In order to attract investors, these groups counterbalance their newly appointed teams› lack of local experience with a more proven track record and the comfort of the franchise value their brands carry. Different approaches are apparent in sourcing deals between local funds and international funds. According to Hernán Cely of Advent International, «the sourcing of deals between local and international funds is very different. Local funds work their local connections, many [of whom] are ex-bankers. The international funds have a more structured and analytical approach that involves analysis by sector.»

In connection with larger funds, PE firms are also looking at larger deals, as illustrated by SEAF. The firm›s first fund invested on average just US$2.8 million per company, often in minority positions. However, its current fund is now targeting an average of US$10 million per investment, with a maximum of US$25 million in deals that include co-investors. Laura Lodoño, of Altra Investments, commented on this dramatic shift in investment sizes, saying that, «initially, most of the opportunities in our pipeline were from $15 million to $20 million; today, we are looking north of [between] $30 million and $50 million per transaction.»

Even as PE firms increase their bets, the Colombian market still has a long way to go. Today, Colombia has only 2% of PE capital allocated to Latin America, and the continent›s total asset base represents 2% of total global resources, according to figures compiled by Proexport Colombia. PE experts suggest that local pension funds should continue to be a major source of additional funding for future growth. In the last 5 years, compulsory and voluntary pension funds have grown by more than 25% a year, reaching a combined asset base of more than US$72 billion as of March 2012. Based on the present regulation, pension funds profiled as moderate or high risk may place up to 5% or 7%, respectively, of their total asset base into the PE asset class. Considering current assets under management, an additional US$1 billion could be allocated to PE investments.

The Investment Horizon: Riding the Wave of Growth

Given the relatively high growth rate and rapidly expanding middle class, it should come as no surprise that the demands for capital continue to increase, especially for industries that are more sensitive to consumer discretionary spending. In the near term, PE investors are finding several sectors particularly attractive — retail, education, health care, housing, tourism and entertainment. Established PE firms in Latin America have also continued to express interest in sectors that will benefit from the country's overall macroeconomic growth as well as in recent trade agreements that could lead to more exports. These sectors include mining, agriculture, business-process outsourcing, IT services and software, and education.

Investment opportunities are arising in more niche industries as well. One such example is Dynamo Capital, a firm that invests in television- and film-related projects. Over the past 5 years, Dynamo has bridged the capital need for a burgeoning film industry in Colombia. According to Alejandra Guzman, the firm's director of investments, these investments not only have been attractive from a financial point of view, but have also contributed to economic growth by providing jobs. Supported by government incentives to help promote job creation and spending in Colombia, these projects can be particularly profitable for local investors with specialized market knowledge, such as Dynamo. It is an example of the potential economic impact that small to medium PE firms can have in the coming years in terms of alleviating capital constraints and supporting job growth.

Meanwhile, no discussion about Colombia would be complete without addressing infrastructure projects. As the country continues to grow and place additional demands on its already stretched infrastructure, the private sector has become increasingly involved in funding projects to address the most critical infrastructure needs, including utilities and transportation systems. PE interest in infrastructure investments has continued to grow, and recent fundraising efforts have indicated that 27% of capital raised has been marked for this sector.

How PE firms deploy this capital has been, and will likely continue to be, segmented into 2 categories: primary investment in infrastructure projects and periphery investments in infrastructure service providers. Larger funds, such as Ashmore and Brookfield, have raised sizable amounts of capital designated primarily for investing directly in infrastructure projects. As an alternative approach, the lower and middle market-sized funds have expressed interest but have generally pursued a strategy centered around investments in outsourcing or service business that would benefit from the presumed growth of these projects. This strategy mitigates the timing risks that can be associated with the projects while still allowing these more generalist firms to participate in the seemingly inevitable growth that will come from the infrastructure sector in the coming years.

Risks and Challenges Ahead

Although the PE landscape in Colombia is broadening along with the country's rapidly growing economy, several challenges still loom on the horizon, including limited track records for funds, a sufficient number of sizable transactions, entrepreneur/manager awareness of PE, and exit opportunities in the future.

A primary challenge that PE firms will face is the task of raising capital for new funds in the absence of a clear returns profile. With both an increase in the number of funds raising capital and an increase in the average target fund size, the competition for capital fundraising will be more intense, and many fund managers will need to convince potential investors of their ability to succeed without a clear track record in the region. Those managers that are successful at fundraising may still face challenges in finding transactions of sufficient size and scale to deploy capital efficiently.

In addition, the industry must work to educate entrepreneurs about the existence of PE capital and the role this funding can play. Most Colombian business owners are just starting to become acquainted with PE and venture capital. The vast majority still do not know what these funds represent and how they can fit in their growth plans. The deal environment in a market such as Colombia is inherently different from other, more established PE markets. Contributing to the difference in the deal environment there is the fact that many of the more sizable businesses are family-owned enterprises, with owners reluctant to accept outside capital and/or relinquish control. As Guzman noted, "It can take a long time to cultivate relationships with these family-owned businesses, and when you do, how do you convince them that a PE investment was a good opportunity?"

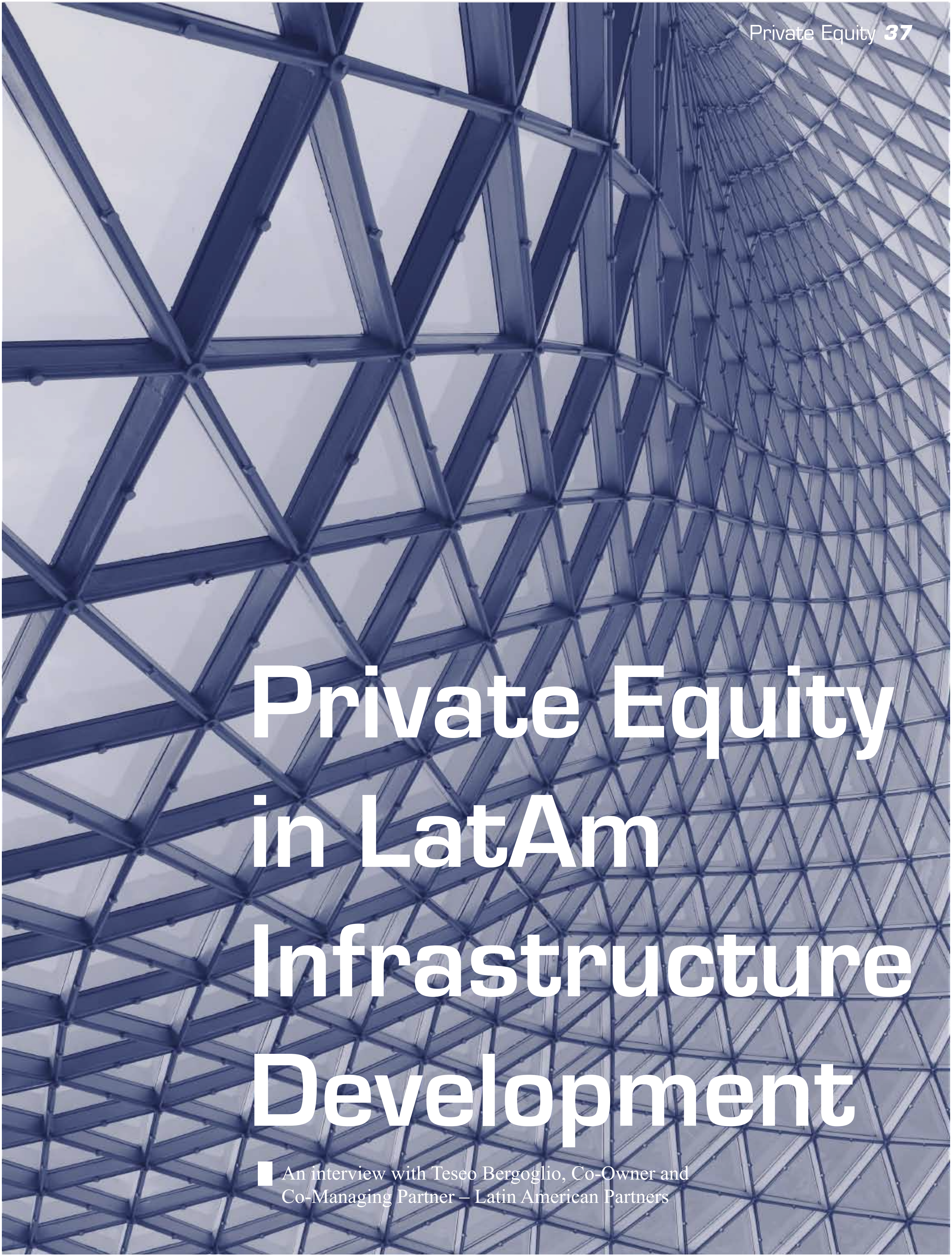
Finally, there is the challenge of finding exit opportunities that allow firms to obtain the liquidity needed to provide returns to their investors. Initially, most PE managers see a strategic sale as the main exit route. However, with the influx of larger international funds willing to write bigger checks, sponsor-to-sponsor exits could become a realistic possibility in the near term, although this is still uncertain. The increased IPO activity in 2011 and the merger of stock exchanges in Colombia, Chile and Peru could also provide another path toward liquidity for PE investors. "The stock market has been rising dramatically recently, with 12 IPOs of mostly blue chips that have added up to more than $8.2 billion in the last 18 months — a historic record for Colombia," says Felipe Iragorri of Tribeca Management. "IPOs for midsize companies should be more of a reality in 2 to 4 years."

Colombia's PE industry will not become a globally significant market until it has established a track record of solid investor returns. Given the lack of this track record, the next investment cycle may prove to be make-or-break for the industry. If fund managers are unable to deliver on the promised economic opportunity, the PE industry in Colombia will struggle to grow at the same pace it has sustained since 2007. However, given the favorable economic conditions, political stability and relatively strong economic position in the region, fund managers up to the task should be able to realize gains that will spur continued

Knowledge@Wharton

Author Biography

This article was written by Rodrigo Boscolo, Ben Shephard and Wallrick Williams, members of the Lauder Class of 2014 and republished with permission from Knowledge@Wharton http://knowledge.wharton.upenn.edu the online research and business analysis journal of the Wharton School of the University of Pennsylvania.



Private Equity in LatAm Infrastructure Development

An interview with Teseo Bergoglio, Co-Owner and Co-Managing Partner – Latin American Partners

Can you tell us about your firm and your role?

LAP Latin American Partners (LAP) is a fund manager with a team of investment professionals that after working together for many years in private equity in Latin America, decided to focus on a sub-region of Latin America and to specialize in mezzanine, which we believe to be more suitable than pure equity for many of our target companies. That is the genesis of the Central American Mezzanine Infrastructure Fund (CAMIF), which has been making mezzanine and equity investments to medium-sized companies and projects in Mexico, Colombia, Central America and selected Caribbean islands. LAP stresses the importance of relations with local sponsors, advisors and governments, and offers regional coverage through offices in Mexico, Central America and Washington, D.C. The firm's investments are made in compliance with international standards regarding environmental, social and anti-money laundering aspects. The owners and co-managing partners of LAP are James Martin and myself who together have 45 years of experience in investment and lending in Latin America.

James has been managing PE and mezzanine investments in Latin America since 1997 for EMP Global (EMPG) and later for EMP Latin America (EMPLA), an affiliate of LAP with main focus on power, transportation, environmental services, natural resources and energy sectors. Prior to joining EMPG, James worked at International Finance Corporation (IFC) where he headed the team responsible for global investments in water and environmental infrastructure and also closed a number of transactions in Latin America in the transportation and gas distribution sectors. Prior to IFC, James worked at BankBoston in Italy, in Mexico as Country Manager, and in Singapore where he was regional head of the Bank's activities in Southeast and South Asia. James has a B.S.F.S. in international economics from Georgetown University and an MBA from Columbia University.

I have been managing PE and mezzanine investments in Latin America since 2001 for EMPG and later for EMPLA, with main focus on shipping, railroads, power, telecom, port, oil services and gas transportation and distribution. Prior to joining EMPG, I worked at Enron Corporation's Gas and Power Risk Management Group in Houston and Sao Paulo. Prior to Enron, I worked in the Corporate Banking division of BBVA Banco Frances in Argentina, originating and managing a $300 million portfolio of corporate debt, including project financing, acquisition financing, bonds, and syndicated loans across a range of industries. Prior to BBVA, I worked in the automotive industry. I have a B.S. in business from Universidad del Salvador, a master's in economics from CEMA University, and an MBA from Georgetown University.

> *We closed CAMIF at the height of the 2008 financial crisis a few weeks after the collapse of Lehman Brothers and managed to reach the target amount of US$150 million mainly as a result of the strong support of our institutional investors.*

When was CAMIF closed?

We closed CAMIF at the height of the 2008 financial crisis a few weeks after the collapse of Lehman Brothers and managed to reach the target amount of US$150 million mainly as a result of the strong support of our institutional investors, including Inter-American Development Bank (IDB), IFC, Dutch development bank FMO, Finnish Fund for Industrial Cooperation Ltd. and Fondo de Fondos from Mexico, and the GP. Our investors believed in our team and investment thesis even in those difficult times. The fund has been almost fully committed, and fortunately so far we have lived up to their expectations by showing a strong performance of attractive expected returns and healthy liquidity.

As a private equity firm, what are the main indicators of a country's economy and financial markets that you evaluate?

We look for strong economic patterns that lead to sustainable growth and continuous need for infrastructure investment. A key component of the success of an investment is getting the macro prospects right and it is not only about originating the right project at the right time but also about being in the right place. Combining a promising macro outlook with a project with a solid growth prospect provides downside protection to macro swings and unexpected changes in the business.

Within our target region we are attracted by overall macro and sector growth, regional integration, skewed energy matrices and strong prospects for changes in technology.

We also study the regulatory framework of the sectors we are interested in and consider other aspects of the overall investment climate, such as rule of law and the government's attitude towards private investment.

Regarding the financial markets, we look for countries with a clear need for our mezzanine financing and a lack of adequate long-term financing from third parties in terms of amount, tenor and with our tolerance for our level of subordination. Typically by strengthening capital structures with our mezzanine or a combination of our mezzanine and equity, we cover the funding gap that allows companies to mobilize third-party financing senior to us in priority of payment and sharing of security.

So you mainly look for infrastructure opportunities?

Our main focus is basic infrastructure, which in our case is widely defined and includes all forms of power (specifically renewable energy), transport, telecom, water and sanitation. We are, at the same time, growth-oriented so we look for indicators that result in a continuous need for additional infrastructure investment. In our region these indicators include sustained country-specific as well as regional economic growth along with sector-specific shifts that create investment opportunities. As an example, we have found opportunities in the power sector as these countries seek to decrease dependence on expensive thermal generation (diesel, bunkers) toward renewables (hydro, wind, geothermal). In other sectors, changing modes of transportation and growth in data-based telephony are some trends that create exciting investment opportunities for CAMIF.

CAMIF also has the flexibility to lend or invest in other sectors such as natural resources, forestry, agribusiness, housing, real estate, health and education among others, which allows us to take advantage of attractive growth opportunities and achieve a balanced portfolio of investments across different sectors and countries. We have also found a similar compounded effect in sectors with strong prospects for import substitution with sustainable competitive advantages to produce locally. We seek to invest in companies that are competitive globally, as we see that as the best assurance of sustained success regardless of economic cycles.

We decided to focus on a sub-region of Latin America and to specialize in mezzanine, which we believe to be more suitable than pure equity for many of our target companies.

What are the main elements of an infrastructure asset operator that you consider when evaluating an investment?

The key lending principle (which also applies to investment principle) from the 5 C's of lending is the character and reputation of the sponsors and partners. Of course we review the track record of our sponsors and partners but character and reputation is still the main concern, which cannot be overcome by the best shareholder agreement or loan agreement. It is also very important to see that the sponsor has a significant vested interest in the success of the project and we always expect a sizable capital commitment by them.

Our interests should be aligned from the beginning and we should structure the transaction in a way that ensures alignment throughout our holding period. Given that we are growth-oriented, we look for sponsors and partners that share the same long-term view and objective. Once we partner, we look for ways to grow the business through domestic expansion, acquisitions and internationalization.

What do institutional investors find attractive in an infrastructure fund?

Investors are interested in our funds due to our focus on mainly long-term mezzanine financing to infrastructure plays in emerging markets. We specialize in infrastructure, which is continuously in dire need of additional investment in our covered region. Investment in infrastructure in our focus region combines the benefits of typically predictable USD-denominated long-term revenues, usually through long-term contracts with high-growth prospects, low volatility and frequent and consistent cash income to lenders and investors. We focus on a sub-region of Latin America with growing economies that are underserved by institutional investors. And we specialize in long-term mezzanine lending, which is an instrument that provides steady cash flow to the fund and our investors, and clear visibility and mechanisms for the return of the capital invested and its exit prospects.

Our investors also invest in our funds because they are interested in co-investment opportunities. We provide exposure to transactions that are difficult to originate and structure and in most cases would not otherwise be on their radar screen. Our deals require very close monitoring, and our investors typically cannot replicate this commitment of time and resources to individual investments and therefore rely more heavily on our capacity to co-monitor their direct co-investments alongside the Fund's own investments.

Combining a promising macro outlook with a project with a solid growth prospect provides downside protection to macro swings and unexpected changes in the business.

Our ability to mobilize funds from our own investors is also attractive to our portfolio companies given that we can add value beyond the resources that we have at our own disposal. Our investors take advantage of our due diligence and analysis and can expedite their own decision process when analyzing direct co-investment opportunities with the fund. So far, we have created co-investment opportunities for our investors that are a significant multiple of the total funds committed to the fund and we expect to continue to do so in the future.

Still on institutional investors, what trends do you see in terms of: (i) their appetite for the asset class; (ii) the way they get exposure to the asset class: financial instruments (listed and not listed); participating in specialized PE funds; or direct investing?

We have seen an increasing appetite for the region for several years now as Latin America has gained a bigger share of total fundraising within emerging markets PE funds and a bigger share of total investments. Institutional investors that invest in our funds continue to invest through specialized funds, combine in-house investing and lending with third-party manager efforts and are increasing their appetite for direct investing as well. We have seen some cases in which those institutions are setting up in-house asset management capabilities. All these trends will benefit the region, which should receive an increased share of capital inflows that would fund growth and development.

Do you seek control of assets?

We lend and invest in companies which, as is the general case in this region, are typically mid-sized family-owned firms that do not want to permanently lose control or suffer heavy dilution; therefore our mezzanine product is more palatable to them. We look for companies with strong management and proven track records that do not require heavy intervention from a financial institution like ours and therefore we do not need to seek majority stakes or control of those assets. But through loan covenants and/or supermajority right we ensure the necessary influence in the company.

We tend to add value not only by injecting long-term capital that represents a significant amount in the overall capital structure, but also by mobilizing third-party capital and financing, usually from our own club of investors that contribute additional funds directly beyond those provided by the fund. Therefore, we tend to be a significant portion of the capital structure of those companies, and we hold significant minority positions which convey certain negative control rights but at the end of the tenor of our loans, owners usually regain full control and ownership.

9. What is the typical holding horizon of the fund and what recent transactions have you done in the region?

Regarding the financial markets, we look for countries with a clear need for our mezzanine financing and a lack of adequate long-term financing from third parties in terms of amount, tenor and with our tolerance for our level of subordination.

We are flexible and try to adjust our horizon to the specific needs of the companies and the preferences of the sponsors but given our main focus on infrastructure, we have to provide enough tenor to allow those projects to materialize and grow, and also match the increasingly long senior financing available in the region. In general, we have the preference to make long-term investments averaging 8-10 years which differentiates ourselves from other funds active in the region.

The mezzanine product typically combines a loan element with equity features which allows the fund to share in the upside of the project. Mezzanine is very flexible and has allowed us to finance a range of opportunities, from expansions of existing businesses to acquisitions and turnarounds. We have done straight acquisitions of minority and majority positions and we have also supported and financed minority shareholders to increase their ownership positions (LBOs) and even managements to acquire control ownership stake (MBOs). We have also done corporate restructurings and turnarounds as well as greenfield projects. In many cases we have done transactions in which we combined a direct investment in the equity of the company with a mezzanine financing with equity features of its own.

In terms of sectors we have invested in several renewable energy companies in hydro generation and biomass, in various ports terminal operators dedicated to bulk cargoes, both dry and liquid, as well as containers. We have also invested in telecom and in agribusiness.

How do you envision possible exits in the LatAm region?

While funds invested in the '90s in Latin America hoping that the capital markets would develop enough to make IPOs a likely exit venue, with the exception of Brazil in the later years, in the vast majority of the cases exits took place through trade sales to strategic investors. In our regional coverage of Latin America, we expect that trade sales will continue to be the most likely exit route in the years to come.

We come from a background of private equity and learned that in spite of closely monitoring investments through their life cycle and adding value for many years, the success of those investments depended mainly on one single liquidity event in the later years of the fund. Therefore we were exposed to exogenous factors (e.g. macroeconomic cycles) that could severely impact the return on those investments if they were to occur during the divesting years.

A key lesson learnt from our past experience in PE was to move to a mezzanine instrument and reduce our dependence on this single exit event as we now receive our return of capital and our return on capital during our holding horizon. The exit-related component of our overall return is no longer the make-it or break-it event it is for a private equity investment. However, our investment style continues to be more involved and hands-on like private equity.

Is there a secondary market for private equity stakes in infrastructure projects?

Even though global M&A activity has declined to a lower level after the 2007/2008 crisis, given that Latin American economies were not as affected as other developed economies, we saw overall M&A activity to suffer less in Latin America. In addition to this better performance compared to other regions, we saw infrastructure M&A activity to also be one of the strongest in Latin America, which experienced a rebound even since the global economic slowdown. There are local and cross-border trade sales taking place and we expect this trend to strengthen in both Latin America and the infrastructure sector in particular. The level of M&A activity within the Latin American region and by foreign bidders acquiring Latin targets is expected to increase or even significantly increase in the next few years which should benefit PE investing in this space.

Speaker Biography

Teseo Bergoglio is a Partner at EMP Latin America and a Managing Director at EMP Global. Mr. Bergoglio has been working for the AIG-GE Capital Latin American Infrastructure Fund L.P. since 2001. He has worked on investments in transportation, power, telecom, cable television, and gas transportation and distribution. He is currently a director of five of LAIF's portfolio companies and affiliates. Prior to joining EMP Global, Mr. Bergoglio worked at Enron Corporation's Gas and Power Risk Management Group in Houston and Sao Paulo. From 1995 to 1999, Mr. Bergoglio worked in the Corporate Banking division of BBVA Banco Frances in Argentina, originating and managing a US$300 million portfolio of corporate debt, including project financing, acquisition financing, bonds, and syndicated loans across a range of industries. From 1991 until 1995, Mr. Bergoglio worked in the automotive industry in Argentina in the areas of finance, accounting, and cash management. Mr. Bergoglio has a B.S. in Business from Universidad del Salvador in Argentina, a Masters in Economics from CEMA University in Argentina, and a MBA with Distinction from Georgetown University.

2012 Key Trends in Latin American Hedge Funds

The Latin American hedge fund industry has continued to provide remarkable performance and growth for hedge fund investors over the years and the Eurekahedge Latin American Hedge Fund Index has delivered impressive annualised returns of 15.62% since December 1999. Since the financial crisis of 2008, the industry has also posted a remarkable recovery in terms of assets under management (AUM).

At the start of 2000 there were just over 100 hedge funds in the region managing US$2.3 billion. Over the next seven years the industry witnessed tremendous growth as investors poured capital into hedge funds and emerging markets. By mid-2008 Latin American hedge funds managed assets of US$58.4 billion while the fund population had grown to more than 450 funds.

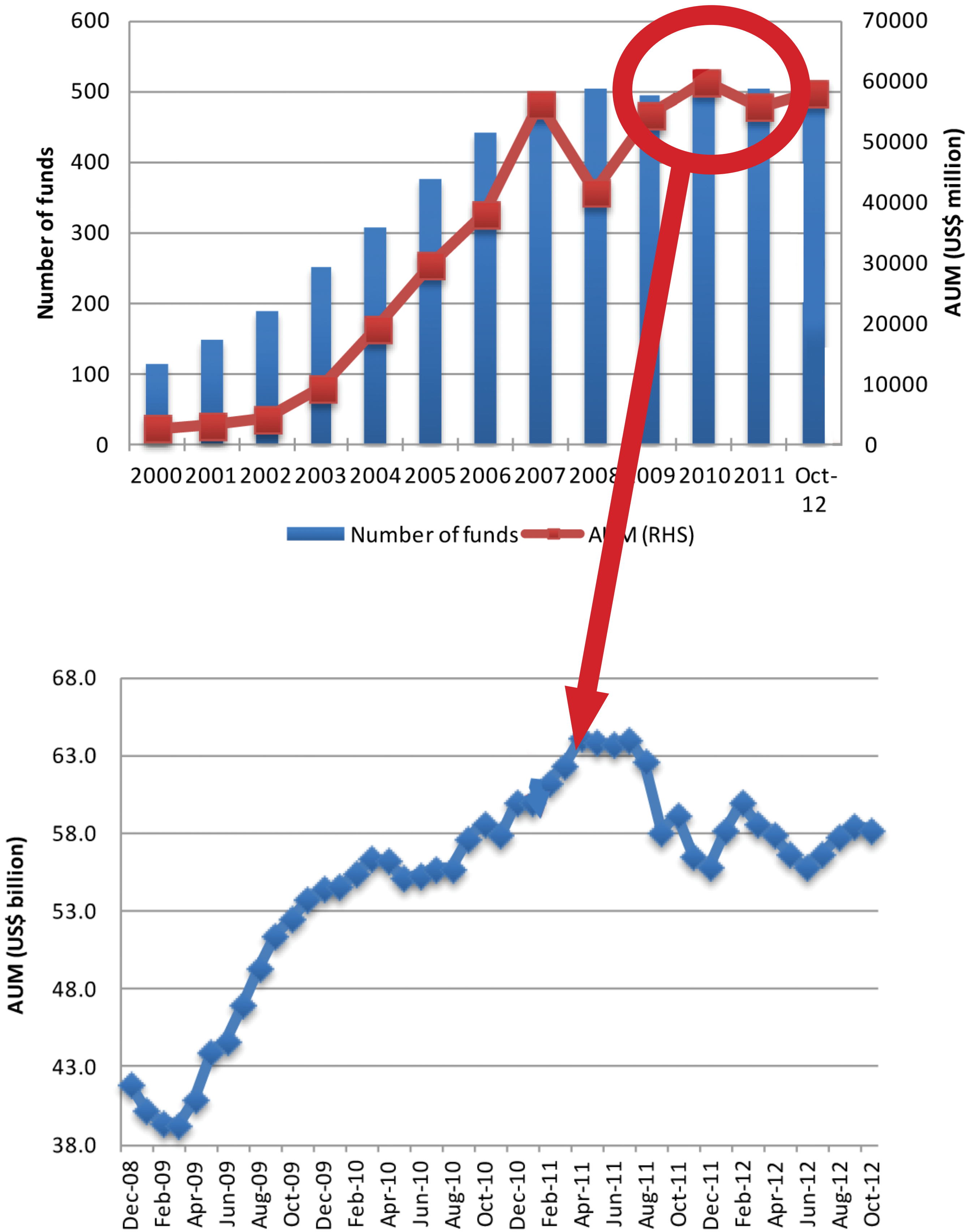
During the global financial crisis, Latin American hedge funds also witnessed some negative returns and redemptions, although not on the same scale as global hedge funds. The average Latin American hedge fund lost 5.88% in 2008, while the average global hedge fund was down 10.13%. Assets under management (AUM) in the industry declined to US$39.3 billion by March 2009, but have since posted a remarkable recovery. Over the next two years managers posted excellent gains while also attracting capital and by April 2011 the AUM in Latin American hedge funds had reached a historical high of US$64.2 billion.

As global markets cooled down due to overwhelming concerns about the European debt crisis and the strength of the global economy, assets in Latin American hedge funds have also declined primarily due to net negative asset flows.

Asset flows

The rebound in global markets since March 2009 resulted in excellent performance-based growth, as well as some positive asset flows to Latin American hedge funds.

Figure 1: Industry growth since 2000



In addition to excellent returns in 2009, the industry also attracted US$5.9 billion via net asset flows during the year to take its size to US$54.5 billion by the start of 2010, reaching its maximum size of US$64.2 billion in April 2011. Since then, asset flows have been negative on the whole while performance-based gains have not been substantial. As the European debt crisis unfolded, global markets took a bearish turn thereby negatively effecting performance-based gains. Investor sentiment was further dampened by the weakening global economic data in 2011 and 2012 while global events such as natural disasters and unrest in the Middle East added to waning risk appetite. These developments impacted asset flows to hedge funds as investors sought to either hold on to their capital or invest in safety assets. Total AUM in Latin American hedge funds fell to US$55.8 billion by end-2011. Consistent performance by the funds has served to allay investor fears while also adding performance-based gains to the total asset size. Currently, the size of the Latin American hedge funds industry stands at US$58.3 billion.

Although the growth in AUM of Latin American hedge funds has not been as strong as that seen in the 2000 to 2008 time period, Latin American hedge funds have posted stronger growth in comparison to global hedge funds. As displayed in figure 2, the AUM of global hedge funds still remains at 4.8% below the January 2008 level, while Latin American hedge funds are ahead by 4.7%. Since March 2009 the assets in Latin American hedge funds have witnessed growth of 48.3% while those in global hedge funds have increased by 34.2%.

Latin American hedge funds are further split into onshore and offshore vehicles – this distinction is based on the funds' domicile. Between 2000 and 2007, most of the growth in Latin American hedge funds was generated by offshore vehicles – surprising given that onshore vehicles have mostly performed better than offshore funds. By

Table 1: Monthly asset flows in Latin American hedge funds since January 2010

Month	Net growth (performance)	Net flows	Assets at end
2009	6.6	5.9	54.5
Jan-10	0.1	0.1	54.6
Feb-10	0.1	0.8	55.5
Mar-10	0.6	0.3	56.4
Apr-10	0.2	(0.3)	56.3
May-10	(0.5)	(0.6)	55.2
Jun-10	0.3	(0.2)	55.3
Jul-10	0.6	(0.2)	55.8
Aug-10	0.5	(0.5)	55.8
Sep-10	1.0	1.0	57.7
Oct-10	0.9	0.0	58.7
Nov-10	(0.0)	(0.7)	57.9
Dec-10	1.1	1.0	60.0
2010	4.9	0.7	60.0
Jan-11	(0.1)	0.2	60.1
Feb-11	0.4	0.8	61.3
Mar-11	0.5	0.6	62.5
Apr-11	0.8	0.9	64.2
May-11	(0.1)	(0.2)	63.9
Jun-11	(0.3)	0.1	63.7
Jul-11	0.1	0.2	64.1
Aug-11	(0.2)	(1.2)	62.6
Sep-11	(0.8)	(3.6)	58.2
Oct-11	0.6	0.5	59.2
Nov-11	(0.2)	(2.4)	56.5
Dec-11	0.2	(0.9)	55.8
2011	0.8	(5.0)	55.8
Jan-12	0.9	1.6	58.2
Feb-12	0.9	0.9	60.0
Mar-12	0.1	(1.5)	58.7
Apr-12	0.3	(1.1)	57.9
May-12	(0.4)	(0.9)	56.7
Jun-12	(0.1)	(0.7)	55.9
Jul-12	0.7	0.2	56.8
Aug-12	0.3	0.7	57.8
Sep-12	0.3	0.5	58.6
Oct-12	(0.0)	(0.3)	58.3

Note: All figures are in US$ billion, and rounded up to 1 decimal place

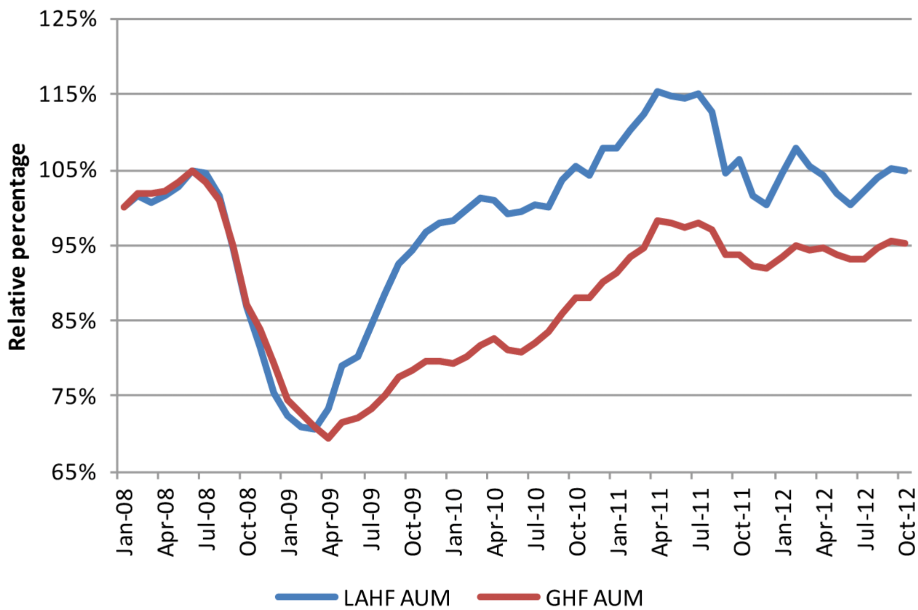
Source: Eurekahedge

the end of 2007 offshore Latin American funds managed US$43.8 billion, or 78% of total industry assets.

During the 2000 to 2007 time period, offshore fund structures were very much in demand as managers had more flexibility to pursue various investment styles without getting tied down by regulations. Onshore hedge funds, also known as multimercado funds, are mostly located in Brazil, require registration with the Brazilian authorities and are regulated in the same manner as mutual funds – needing to meet requirements such as providing regular net asset values, transparent pricing policy and a centralised clearing house to reduce counterparty risk.

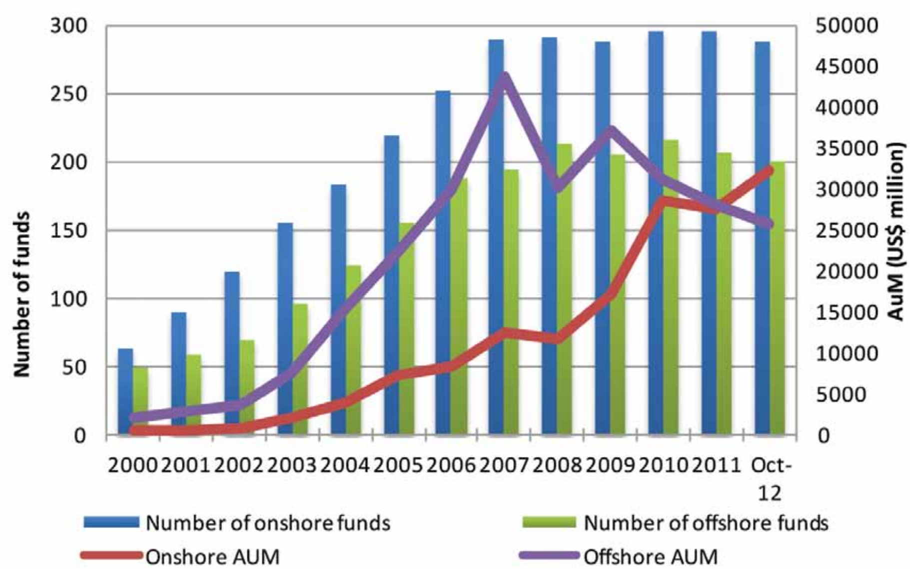
In the post-financial crisis environment, these aspects of onshore funds have become quite attractive to investors. Additionally the increasing prosperity within Brazil (which is home to the bulk of onshore funds) has also driven growth in the onshore funds industry since the country boasts strong GDP growth and an increasing number of high net worth individuals (HNWI). As many of the local funds are regulated retail vehicles, they can also be marketed to the burgeoning middle class retail investor. Due to these reasons the AUM of onshore hedge funds has now overtaken that of the offshore industry.

Figure 2: AUM growth of Latin American hedge funds versus global hedge funds



Source: Eurekahedge

Figure 3: Industry growth of onshore and offshore funds



Head office locations and fund domiciles

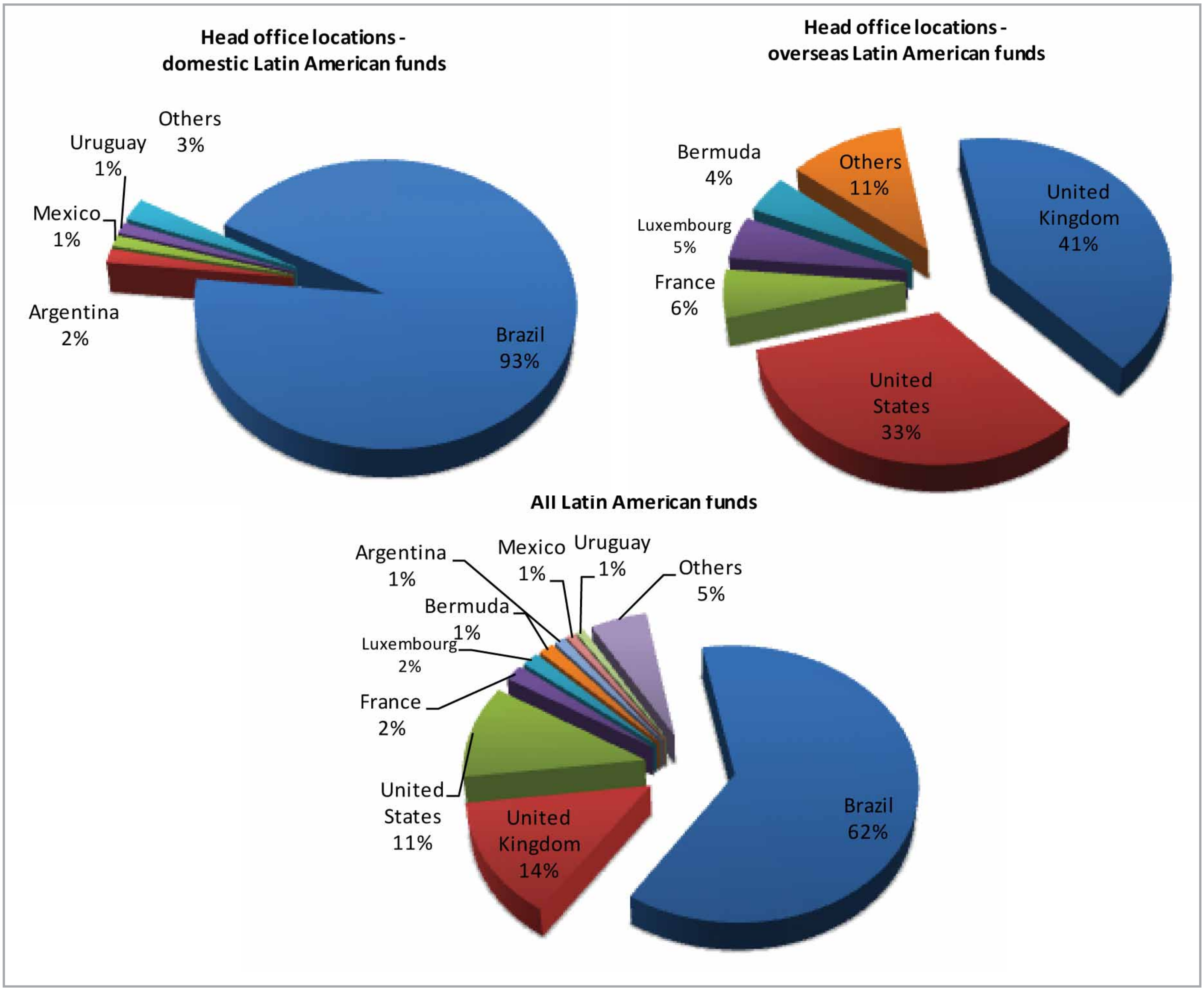
Head office locations within Latin American hedge funds can be broken down into two categories – funds located in Latin America and funds located outside of Latin America. The domestic industry is dominated by Brazil, accounting for 93% of the funds – most of which are located in either Sao Paulo or Rio de Janeiro. Additionally an increasing number of international firms are opening their offices in the country to take advantage of the growth opportunities – notable names that have recently made moves in the region include Highbridge, Brevan Howard and FRM. In addition, a number of local hedge funds have indicated their intention to raise capital from outside the region, which would trigger substantial growth in the sector.

In terms of non-domestic Latin American hedge funds, the UK and US hold the top two spots, together accounting for almost three quarters of overseas Latin American funds. In the overall picture Brazil once again comes out on top with 62% of the funds, and we expect this share to increase further as more firms launch their Latin American funds in the country.

Geographic mandates

In terms of distribution of assets by geographic mandates, we can observe a trend over the last five years of an increasing focus on Brazilian investments. Since October 2007, the share of Latin American hedge fund AUM in Brazil focused funds has increased by 12.3%, while the share of funds investing globally has decreased. This is primarily due to the increased asset flows to the local hedge funds and also because of their stronger performance vis-a-vis other regional mandates. Furthermore, the region also drew a relatively greater share of assets from large international globally investing and emerging markets funds as compared to other regions such as emerging Europe and Asia ex-Japan, as both were impacted harder by the global economic recession.

Figures 4a-4c: Head office locations by number of funds



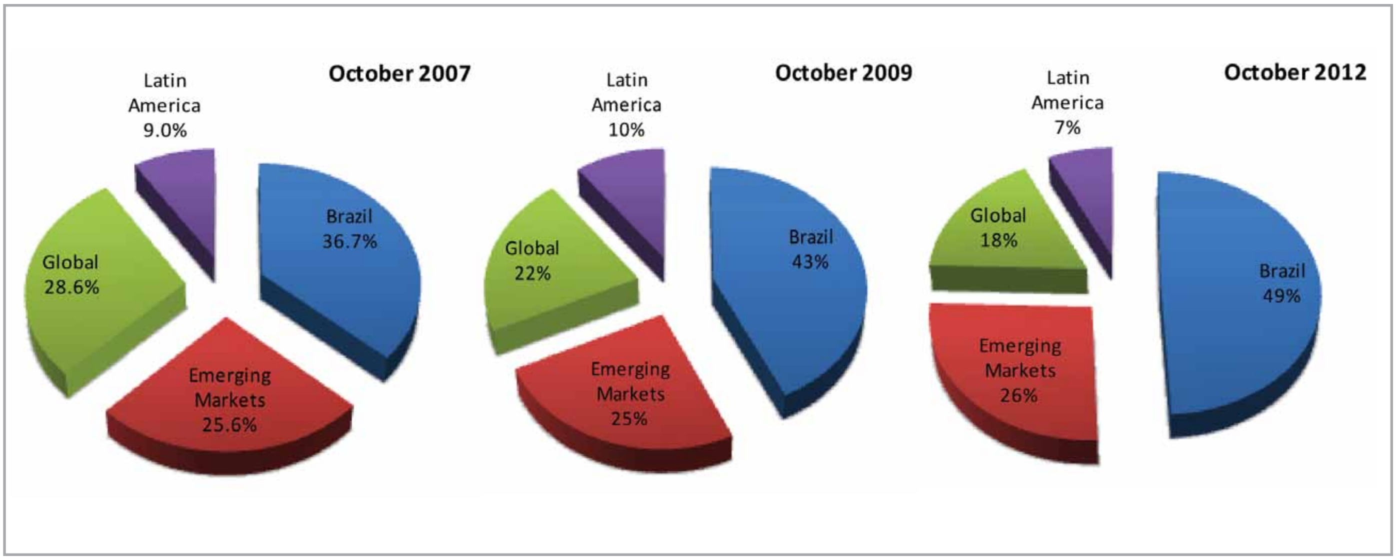
Going forward we expect this share of AUM in Brazil investing hedge funds to increase due to the strong fundamentals in the country as well as the expected developments due to the upcoming football World Cup in 2014 and Olympics in 2016. The country has one of the largest stock markets in the world, a network of service providers and a strong talent pool of financially trained professionals, while a rapidly increasing middle-class and high net-worth population will provide further marketing opportunities to local multimercados which can be marketed to retail investors and also to HNWI.

Strategic mandates

The share of assets in Latin American hedge funds across the different strategies has also witnessed some slight changes over the years. The overall similarities in this breakdown also highlight the fact that Latin American hedge funds were more protected during the financial crisis than hedge funds in other regions.

Multi-strategy investing remains the most popular strategy with 33.6% of the assets,

Figure 6a-6c: Strategic mandates by AUM



Figures 7a-7c: Industry breakdown of hedge funds by fund size (US$ million)

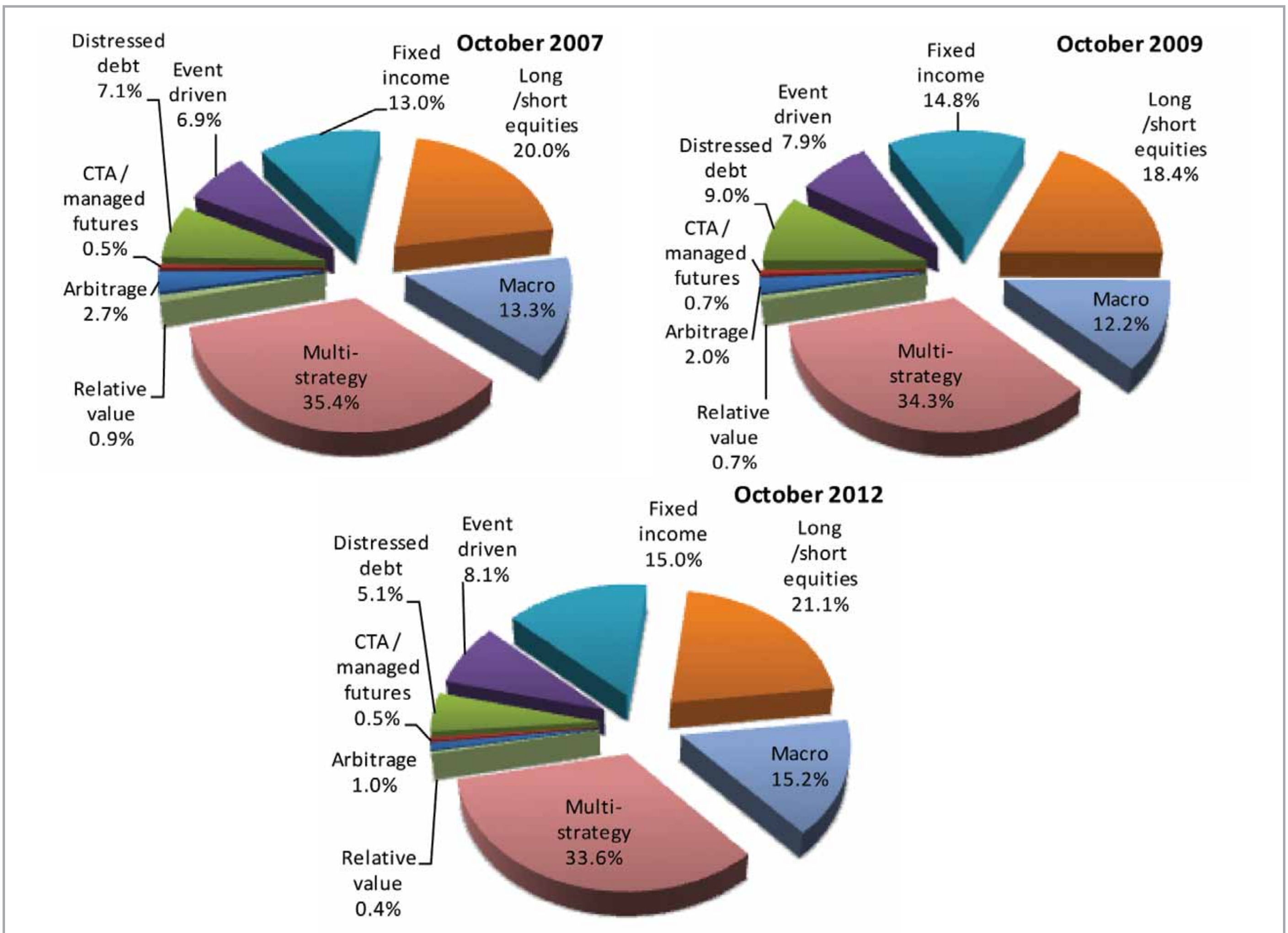


Table 2: Performance of Latin American hedge funds and other investment vehicles

	Eurekahedge Latin American Hedge Fund Index	MSCI EM Latin American Index	Eurekahedge Hedge Fund Index
October 2012 year-to-date returns	7.99%	5.72%	3.97%
2011 returns	1.92%	(13.49%)	(3.23%)
3 year annualised returns	7.88%	2.81%	4.72%
3 year annualised standard deviation	4.07%	14.05%	5.05%
Sharpe Ratio (RFR = 2%)	1.45	0.06	0.54
Maximum Drawdown (3 years)	(3.54%)	(19.97%)	(6.68%)
% Below HWM	0.00%	(11.33%)	(2.35%)

Source: Eurekahedge

hardly surprising since these mostly comprise the local multimercado funds in Brazil. Long/short equity managers are the second largest group primarily because Brazil is home to one of the largest stock markets in the world with a market capitalisation of US$1.16 trillion. The share of assets in long/short equity funds declined significantly during the financial crisis from 20% at the end of 2007 to 13% by March 2009 before rebounding later that year. Since then this share has increased to its previous levels due to strong performances posted by regional long/short equity managers as well as some positive asset flows. It is interesting to note that given the regional economies have a strong dependence on raw material exports, there are very few commodity trading advisors or funds focused entirely on the asset class. Managers looking to gain exposure to commodities either invest the equities of commodity producers or employ multi-strategy and macro mandates.

Fund sizes

In terms of fund sizes, the industry has witnessed some significant trends. The percentage of funds with AUM of US$20 million or less has increased steadily over the years to account for 33% of the funds. This is due to lower asset flows to newly launched funds, while outflows and performance-based losses during the financial crisis also pushed some of the funds from higher AUM categories to the US$20 million range.

These figures vary considerably from the pre-financial crisis breakdown when there was more equitable distribution of funds across the different AUM ranges. This also suggests that the trend of asset flows and growth over the last few years has been focused on a few large hedge funds. In fact funds with US$500 million or more, which are only 7% of the fund population, account for more than 53% of the assets in Latin American hedge funds.

Performance review

The section explores the performance of the Latin American hedge funds industry as a whole and we also look at the performance breakdown by geographic and strategic investment mandates in 2012, 2011 and over the last three years.

Figure 8 displays the Eurekahedge Latin American Hedge Fund Index, Eurekahedge Hedge Fund Index and the MSCI Latin American Index since December 1999. The overall performance of the Eurekahedge Latin American Hedge Fund Index is well ahead of the other two indices due to rapid economic growth in the underlying markets over the last 12 years and the downside protection ability of the managers. In 2012, the Latin American hedge funds have posted a relatively strong 7.99% October year-to-date return, outperforming the underlying markets and also hedge funds in other regions.

Table 3: Performance of geographic mandates

	Brazil investing	Emerging markets investing	Global investing	Latin America investing
October 2012 year-to-date returns	9.00%	4.74%	7.28%	5.33%
2011 returns	4.85%	(7.34%)	(11.62%)	(4.69%)
3 year annualised returns	9.28%	2.63%	2.63%	4.43%
3 year annualised standard deviation	3.45%	7.18%	6.77%	5.79%

Source: Eurekahedge

Table 2 compares the performance statistics in detail for the above indices. Over the last three years, not only has the Eurekahedge Latin American Hedge Fund Index out-performed other investments in absolute returns, it has also reported a much lower volatility with a 4.07% annualised standard deviation. Latin American hedge funds also have the smallest maximum drawdown among the different investment vehicles, over the last three years. In 2008, the average Latin American hedge fund only lost 5.88% while global hedge funds were down 10.13% during the year.

Table 3 is a comparison of the performance of each of the geographic mandates employed by managers with exposure to Latin America. Brazil focused managers come out ahead in all the three time periods under consideration. Brazil hedge funds are usually marked by low net exposures, thereby countering some of the negative impact of the market declines. Additionally these funds are mostly denominated in the Brazilian real, and hence the effects of currency depreciations do not have a negative impact on their portfolio returns vis-a-vis funds denominated in other currencies and investing in the region. Additionally one of the main reasons for the stronger return of Brazil focused funds is the high interest rate of the Brazilian real – and funds denominated in the currency have an added layer of earnings from interest.

Latin American funds that focused on the broader region have also delivered gains

Figure 8: Performance of Latin American hedge funds, global hedge funds and market index

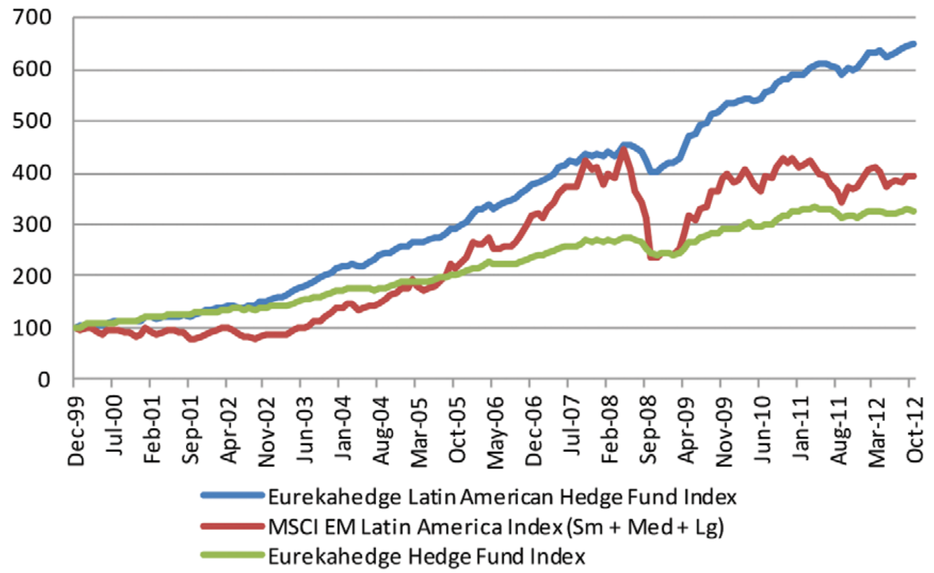


Figure 9: Performance of geographic mandates

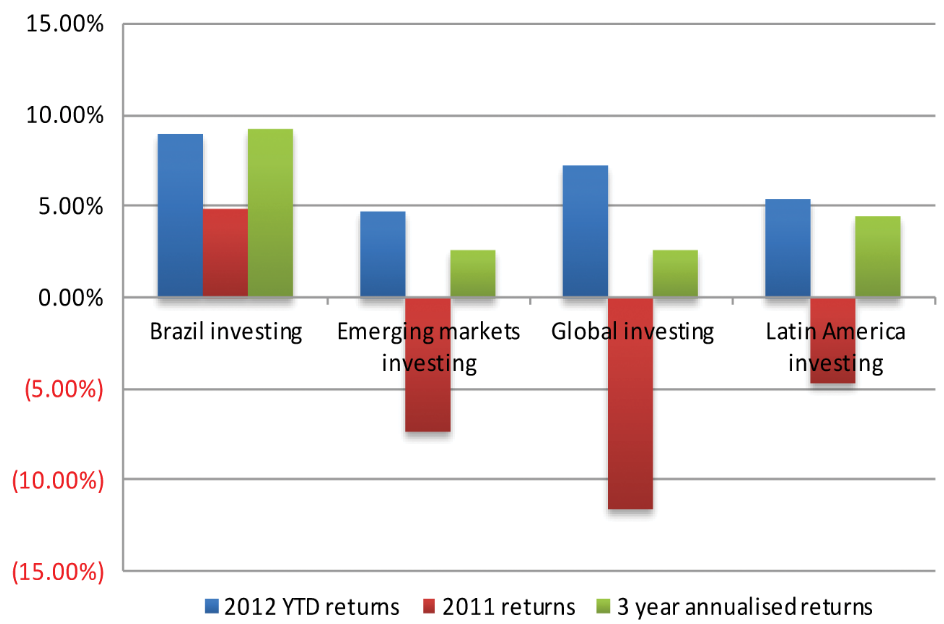
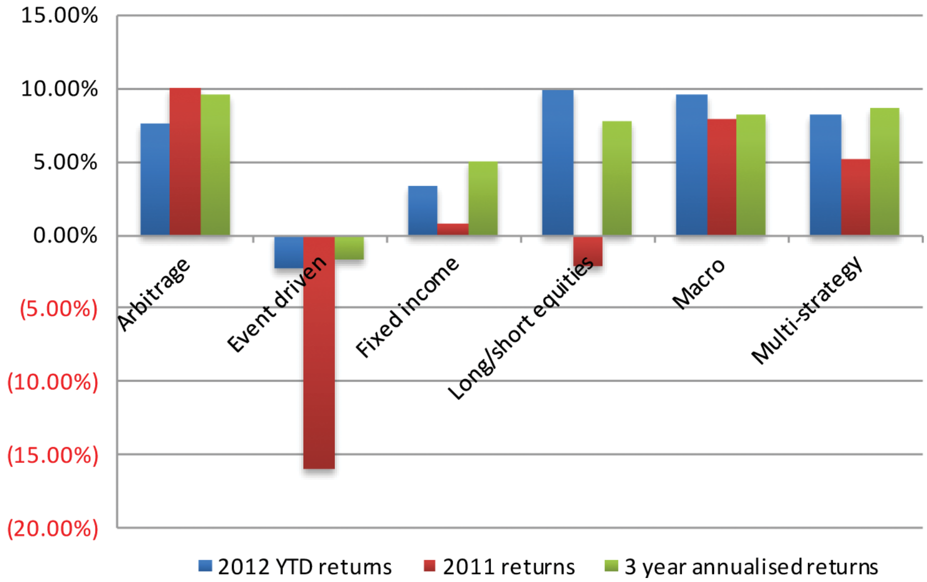


Table 4: Performance of strategic mandates

	Arbitrage	Event driven	Fixed income	Long/short equities	Macro	Multi-strategy
October 2012 year-to-date returns	7.64%	(2.30%)	3.37%	9.85%	9.62%	8.27%
2011 returns	10.13%	(15.95%)	0.80%	(2.12%)	7.90%	5.14%
3 year annualised returns	9.68%	(1.67%)	5.05%	7.86%	8.25%	8.72%
3 year annualised standard deviation	1.25%	9.88%	4.21%	5.87%	2.79%	3.17%

Source: Eurekahedge

Figure 10: Performance of strategic mandates



from their exposures to markets other than Brazil. Developments and growth in Chile and Mexico have fuelled the portfolio returns of regional outperformers. These two countries have gained increased importance among investors and a number of managers are now gravitating towards including them in their portfolios.

Based on historical performance, hedge funds with an arbitrage strategy have generated profits consecutively over the last three years, averaging 9.68% annually, and having the lowest risk association. In fact Latin American arbitrage hedge funds have delivered exceptional returns over the last 12 years – since its inception in December 1999 the Eurekahedge Latin American Arbitrage Hedge Fund Index has gained more than 430% and has only witnessed three months of negative returns over the last 12-plus years.

Most strategic mandates have delivered healthy returns during in 2012, with the exception of event driven funds which are down 2.30% October year-to-date. This is mostly a result of the hard sell-off in the regional markets witnessed in May 2012 when the onshore Latin American event driven funds lost 8.80%. These results were driven by a sharp fall in risk appetite, the MSCI Latin America Index was down 7.17%, regional currencies declined substantially while commodity prices were also down significantly during the month. Performance of event driven funds has improved since then and a number of managers have reported gains from increased corporate activity in the region, such as the merger of LAN and TAM airlines.

Long/short equity managers in the region have delivered excellent returns so far in 2012 gaining 9.85% October YTD. This comes as a substantial outperformance of the underlying markets which are up 5.72% over the same period of time. Many managers have realised gains from exposure to the region's infrastructure opportunities by investing in the equities of developers and other related firms. Macro and multi-strategy hedge funds have also delivered strong returns for the year, up 9.62% and 8.27% respectively. Even though the local currencies have declined against the US dollar, managers have still been able extract value from different asset classes. Additionally some macro managers also reported gains through short exposures in the local currencies in 2012.

EUREKAHEDGE

Company Biography

Eurekahedge is the world's largest independent data provider and research house focusing on alternative investments. We are headquartered in Singapore and have representative offices in New York and London. We maintain coverage on over 26,000 alternative funds globally.

Our global alternative research covers hedge funds, funds of hedge funds, private equity funds, Islamic funds, real estate funds, long-only absolute return funds and enhanced equity funds (130/30) and socially responsible investment funds (SRI).

www.eurekahedge.com

No Slowing Down

Felipe Iragorri of Tribeca Asset Management Sees Continued Room for Growth in Colombian PE

Over the last half decade, a convergence of propitious factors has turned the Colombian PE market from an underdeveloped latecomer into one of the most attractive markets in LatAm. With only 4 local funds in existence before the landmark regulatory reforms of 2007, over 20 funds were raised in the next 3 years — and the country's attractiveness has only grown since.

Global firms have joined these local managers in an increasingly competitive market, as they see Colombia (along with Mexico and Peru) as one of the highest-potential markets in the region. A recent report from Knowledge@Wharton (quoting Balcoldex Capital) has the total AUM of funds in Colombia at US$2.2 billion, with some experts believing that total could double in the coming years.

But as these newly formed funds are helping constitute a more fully-fledged market, some of the managers from Colombia's first PE wave continue to thrive. Chief among them is Tribeca Asset Management. Founded by Felipe Iragorri and Luc Gerard in 2006, the firm has been instrumental — both as a model and through working with regulators — in paving the way for the newest generation of managers and PE investments.

Tribeca focuses on small cap and middle market investments across several sectors, including energy, health care, education, consumer goods and services, infrastructure management, natural resources (including mining) and green industries (where the focus is on waste management). It has raised and invested 2 funds: 1 with US$132 million AUM, the other with US$250 million AUM; the latter consists of 4 distinct vehicles with the same vintage years. Tribeca has also orchestrated several successful exists, including Latco, the oil-drilling company, in 2010. The firm is currently raising a 3rd fund.

Takeaways

- A confluence of factors, including improved regulations, macroeconomic growth and reduced crime, have led to an explosion of PE fund activity in Colombia.
- Some of the best opportunities are in the consumer sectors as well as infrastructure, where the government is putting its weight to get the country caught up.
- Far from there being a "bubble," Colombia's growth is healthy, its rising prices normal, and its middle and small cap markets still flush with good deals.

Strong Foundation

Mr. Iragorri — who initially handled virtually all aspects of running the firm, but now focuses on health care and education investments as an Investment Director, while sitting on the board that oversees all of Tribeca's investments — has seen drastic improvements in the PE ecosystem in Colombia since his firm's inception. Much of this, of course, has to do with the macroeconomic improvements of the last few years.

"Colombia is growing and it has the pillars in place to support it," he says, noting that Colombia is the 3rd largest economy in Latin America, the 3rd largest population in the region and the 2nd largest Spanish-speaking market in the world. "Foreign investment has grown 7-fold in the last 10 years, which is very impressive," he adds. He also points to the increasing openness of the economy, ranking it alongside Mexico and slightly behind Chile. "It has new free trade agreements with the US, Europe and South Korea; and the first 10 years of an FTA are always good for both parties, but especially the emerging market."

Getting the Story Straight

Yet he stresses that, while Colombia's recent growth numbers are impressive, they're a continuation of a long history of economic strength, an important characteristic of Colombia's history that was long overshadowed by the reputation for drugs and violence that haunted it until recently.

"When we started in 2006, the Colombian story was difficult to pitch," Mr. Iragorri recounts. "You saw a huge asymmetry of information, where everyone talked about drugs and violence instead of how Colombia is one of the longest-standing democracies in Latin America, has never defaulted on its debt in history, and has had only one negative growth year in the last 80 years. So this story of violence made the country's growth potential lag, but now it's more something of the past, and I think the peace talks we're looking at now will help spur growth even more."

Tribeca's investors historically have been from the US and Europe, particularly Spain, Germany and the UK; Canada has recently become prominent, as well. The big story now, Mr. Iragorri says, is intra-regional investment, with Chile being the largest foreign direct investor in Colombia in 2012 — most notably through Cencosud's purchase of Carrefour's Colombia assets.

"I don't see a bubble in Colombia. Asset prices have increased, of course, and not only real estate but financial assets as well; acquisition prices and multiples are going up, but I see a lot of potential still, particularly in mid-market investments between US$20 and $80 million, which is our target."

— Felipe Iragorri, Partner & Investment Director, Tribeca Asset Management —

Bubble Talk

The investment rush has led to rising prices, with some analysts wary of a Colombian bubble, but Mr. Iragorri doesn't buy it.

"I don't see a bubble," he says. "Asset prices have increased, of course, and not only real estate but financial assets as well; acquisition prices and multiples are going up, but I see a lot of potential still, particularly in mid-market investments between US$20 and 80 million, which is our target."

He adds that infrastructure is a sector with immense growth potential, as Colombia is currently lagging in that area against its peers in the region. "We see a huge opportunity there, especially as the government is looking to invest between US$40 and $50 billion in the next 4 years," he says.

Upping the Competition

Mr. Iragorri concedes that competition has increased drastically, as Tribeca and Altra Investments — another of the early success stories in the homegrown Colombian PE space — are no longer the only game in town; but he sees the competition as a positive development for the market in general, and even for his firm in particular.

"It's a competitive market and we'll see more and more come from third-party strategic investors," he says, "but those strategic investors coming in are also exit opportunities for us, as are some of the big players, so it's important to see it both ways."

As for where investors should put their money, Mr. Iragorri thinks that firms like his — with their blend of experience, local knowledge and middle market focus — are the sweet spot.

"I would look at players who have a track record in the market and have been there a while; have a local team with experience and contacts for sourcing deals; are focused on mid-market or small-cap over large cap; and have carried out successful exits, as the industry is young and there haven't been a lot of successful exits yet."

Patience Is a Virtue; Dollars Too

In Spite of the Global Recoil from Argentina, Jeronimo Bosch of Grupo Pegasus Sees Strong Investment Opportunities

Takeaways:

- Notwithstanding the global recoil from Argentine assets, there are still some strong opportunities there for investors with patience, selectivity and dollars.
- Consumer retail, agriculture and agribusiness are among the top sectors.
- Utilities may also present opportunities, as the government sells off assets it can't manage on its own.

Since the resurgence of the PE market in LatAm last decade, Brazil has been by far the most attractive market in the region for foreign investors; recently, the Andean region and Mexico have become the consensus picks as the most promising markets in the near term. During that same period, howver, and especially since the government takeover of YPF last year, Argentina has been spurned by the global investment community, often to the point of total neglect. Most investors see its economy as too risky and seemingly crisis-bound, and its government too unpredictably interventionist, to put it mildly.

And yet, for all the bad press and strange government measures, there are still strong investments to be found there, and top-notch managers at work.

"Argentina is clearly out of favor for international investors," says Jeronimo Bosch, Managing Partner at Grupo Pegasus, one of the top investment firms in Argentina. "And yet, having said that, there are still bright opportunities down here, and we're always alert."

Pegasus was founded in 2000, on the eve of Argentina's economic crisis a year later. It works in 2 general business areas, PE and real estate, each receiving more or less half of funds allocated. In PE, Pegasus invests in the agribusiness, financial services, retail and technology sectors. Though its focus thus far has been on Argentina, it invests regionally and is currently raising a Colombia fund. About 80% of Pegasus' investors are foreign.

"The day YPF nationalized, we got a call from someone saying they were interested in investing immediately. It's the totally contrarian view. So you do have some investors internationally who aren't willing to bet the house, but are wiling to put an allocation into Argentina, and if they have fresh legs and some patience it's probably a good time to look at things."

— Jeronimo Bosch, Managing Partner, Grupo Pegasus —

Mr. Bosch stresses that his firm's investment style must be different from those of typical PE firms, because of the nature of its market. "We're not a typical PE fund, not like Southern Cross," he says. "We don't have a blind pool to deploy. We look at making good investments, and when the time is right, we eventually realize any value created throughout investment period."

The style is opportunistic, then, but not in the sense of scouring the market for distressed or undervalued assets. Instead, patience and selectivity based on strong fundamentals are key.

"The issue now is that there aren't as many distressed assets here as people would like to see," he explains. "The economy is relatively sound, macro is more stable than in past crises, there's inflation but not much debt. So people and businesses are not forced to sell, and what that creates is less liquidity in the market, fewer transactions: buyers want to buy cheap and sellers don't want sell cheap. And in the meantime, businesses are actually making some money."

Pegasus' best assets have taken advantage of trends in the consumer market, as well as the demand from abroad for products all the way up the agribusiness food chain. Among its portfolio companies are Farmacity, a CVS-style pharmacy chain and the leader in Argentina, with 195 stores in Argentina; Freddo, the leading premium ice cream producer in South America, with over 100 stores; and Pampa Cheese, which Mr. Bosch says has benefitted from the recent increase in protein consumption in China.

Pegasus has also invested in the tech sector, its top company being Core Technologies, a global leader in preventive security software and one of the top companies to emerge from Argentina's software and internet boom in the 1990s.

On the real estate side, Pegasus deployed a fund in Argentina a few years ago, mostly for development. It has developed the second largest shopping mall in Argentina, Tortugas Open Mall, in Pilar, just outside Buenos Aires; it is currently at 98% occupancy with strong sales, Mr. Bosch says. Pegasus then developed a 50,000-square-meter office building in the northern metropolitan area of Buenos Aires, which is already fully occupied.

Though Argentina has become the "pariah" du jour for the international investment community, Mr. Bosch says there are still investors who are able to brave the noise and spot some healthy opportunities.

"The day YPF nationalized," he says, "we got a call from someone saying they were interested in investing immediately. It's the totally contrarian view. So you do have some investors internationally who aren't willing to bet the house, but are wiling to put an allocation into Argentina, and if they have fresh legs and some patience it's probably a good time to look at things."

He emphasizes patience as the most important quality for investors in Argentina. "If you're looking to make a quick buck, it's probably better to buy an ADR and play that game," he says, "but that's not what we do."

For investors entering Argentina now, besides the consumer retail sector where Pegagus' assets are currently thriving, Mr. Bosch points to agriculture and agribusiness sectors.

"Agriculture has had a difficult 2 years, and if a buyer comes in with fresh US dollars, there are assets you can buy. Some of the trends that have been favoring the sector will continue. But then you have to decide if you want to play land or PE in the food chain, which yields higher returns but is riskier."

He also points to a sector that is far from most investors' minds given the current government's recent actions: utilities.

"There are some question marks there, course, but it is an interesting sector. Utility tariffs have been frozen and these companies are running out of money. The government is saying they'll take over, but they won't be able to take over everything. Even YPF recently signaled that they were going to bring in investors and increase the price per barrel of oil in order to reduce export prices. So there's starting to be some movement and that could be the beginning of a correction in the energy sector."

Post-Brazil PE

Erik Peterson of the Abraaj Group on the Strength of Mexico and the Andean Region

Takeways:

- For global growth market PE investors such as the Abraaj Group, the most attractive region in LatAm ranges from Mexico to Peru.
- These countries are attractive not only for their demographics and growth prospects, but because of the relative soundness of their economies and their governments' seriousness about investment.
- 2013 should mark a true "coming out year" for Mexico.

In 2012, the Abraaj Group, a Dubai-based PE fund manager founded by Arif Naqvi, acquired Aureos Capital, creating one of the largest growth market PE investment firms in the world, with over US$7 billion AUM.

The acquisition helped bring Abraaj into LatAm, where Aureos already managed a portfolio of regional assets. Tellingly, that portfolio contains no Brazilian companies, but is focused exclusively on the region from Mexico to Peru, with 13 investments in that region and Mexico receiving the largest allocation.

This makes Abraaj a rarity among giant global PE funds in LatAm, one focused entirely on the region that is already displacing Brazil as the favorite LatAm market among global PE investors.

"If we look back at 2012, and even more so to 2010 to 2011, LatAm has become the region among the emerging markets that is attracting the most LP interest," says Erik Peterson, Regional Managing Partner for Aureos Latin America, who currently oversees Abraaj's LatAm investments. "Initially it was Brazil, but increasingly it's been Mexico, Colombia

and Peru that have surpassed Brazil as the stars in the region, even though Brazil of course remains the largest economy in the region."

Post-Brazil

This focus on Mexico, Colombia and Peru is exemplary of a shift in LatAm PE. 2012 saw a marked drop in funds raised in Brazil relative to the rest of the region. Though it is still the largest fundraiser, it is clear that global investors are more attracted to the macroeconomics, demographics and growth prospects of its peers to the Northwest.

And yet, few regional funds have zero exposure to Brazil, which makes Abraaj a rarity among mega-firms in the region. "We're one of the few regional players not focused on Brazil," Mr. Peterson notes, "so from an LP's perspective, we provide diversification."

For Abraaj, the big draw of the Mexico-to-Peru region is the story that's on just about everyone's minds: "Our primary focus is on sectors that will continue benefitting from demographic trends in the region and the increasing purchasing power of local consumers and businesses," Mr. Peterson explains. Sectors currently in the portfolio include TMT, retail, financial services, consumer products and health care. Going forward, education and logistics are attractive sectors, he says.

Emerging Eminence

As part of a global firm focused on growth markets, Mr. Peterson has an interesting perspective on LatAm as it compares to Asia. Though he stresses that Asia should not be seen as a uniform bloc but as an assortment of unique, complicated and, in several cases, enormous markets, he does draw some general comparisons, finding certain advantages that LatAm enjoys vis-a-vis Asian markets.

"For example, the political and fiscal environment is relatively transparent and clear," he says. "Rule of law provides clarity and stability, so you can project going forward, and make long-term investment decisions. In addition, Latin American countries generally have strengthened their country balance sheets over the last decade, lowering external debt, and providing a sound basis for domestic programs."

Many of these governments are now in investment mode, trying to build up infrastructure and match needs of growing populations, he says. "Those factors and the continuing global demand for natural resources are contributing to the growth of these countries."

"I think this year will be a coming out year for Mexico. Brazil has dominated in past years, but over the last year Mexico has taken over, and I think it will continue this year. Colombia and Peru, too, should continue the strong growth of the last decade and attract more investor attention over the medium term."

"I think this year will be a coming out year for Mexico. Brazil has dominated in past years, but over the last year Mexico has taken over, and I think it will continue this year. Colombia and Peru, too, should continue the strong growth of the last decade and attract more investor attention over the medium term."

Erik Peterson, Abraaj Group

A Helping Hand

Takeaways:

- Emerging market funds of funds are drawing increased attention from institutional investors who are allocating away from familiar developed markets.
- 57 Stars is a prominent example of a fund of funds manager focused exclusively on emerging markets, with about 25% of its capital currently invested in LatAm.
- LatAm scores well among emerging markets because of the relative maturity of the LatAm PE market and the experience many LatAm managers have in managing through downturns and crises.

Chris Bruneau of 57 Stars on the Role of Funds of Funds as Institutional Investors Enter Emerging Markets

As the developed markets continue to sputter and emerging private equity markets mature, institutional investors are gradually shifting their allocations toward emerging market managers. As they do so, many are utilizing emerging market funds of funds as a way of gaining broad and diverse exposure via experienced fund selectors.

One exemplary fund of funds manager is 57 Stars, which focuses exclusively on emerging markets, including LatAm. Founded in 2005, 57 Stars currently has US$1.7 billion AUM. Its investors include large US institutions such as New York State Common and Guardian Life Insurance, as well as some European institutions and a Middle Eastern sovereign wealth fund, among others. For these investors, 57 Stars offers a firm helping hand as they enter more unfamiliar markets.

"We think our approach and that of some of our competitors is interesting as a first step into the region," says Chris Bruneau, the firm's Executive Director. "With a fund of funds, you can get a diversified portfolio of 5 to 10 PE investments in the region, learn the region, and then make direct commitments down the road."

57 Stars' investments are essentially in corporate private equity, Mr. Bruneau says, including some venture capital, early stage and control strategies, with roughly 90% of the firm's capital in primary partnership investments, where it invests not in a GP but in a fund; it also does co-investments and secondary investments. It invests in numerous sectors and vehicles, but generally not

in infrastructure, real estate, agriculture or credit strategies, as the firm's targeted returns — 2.5x to 3.5x — are higher than those strategies generally provide.

Reading the Market

Currently, 57 Stars has investments in approximately 40 countries, with about 25% of its capital in LatAm. China is the largest single market in the overall portfolio, accounting for about 20%; then India with approximately 15%. As Mr. Bruneau explains, however, these allocation percentages are not fixed, but contingent on the market.

"We don't bucket-fill," he says. "It's really driven by who's coming to market." He describes the approach as "top-down, bottom-up."

"For top-down, we look around the world: Slovenia may be interesting, but it's too small; Indonesia may be interesting from a top-down perspective. More important, however, is bottom-up. We've been around a long time and know who's who. We look ahead 3 to 4 years on our foreign calendar and identify the most interesting 20 to 25 opportunities over that time. One could be a Chinese growth manager, another an Indian early-stage manager, another a Brazilian control player."

Falling into Favor

57 Stars is keen on LatAm private equity currently and in the near term, Mr. Bruneau says, particularly in the middle market and in the emerging Andean region and Mexico.

"Latin American has been, and continues to be, very interesting to us, largely because of the scarcity of capital. Notwithstanding a few mega-funds, from a macro perspective there's not a lot of capital, particularly in the middle markets in Mexico, Colombia, Peru. Even in Brazil, there's competition for large deals among the larger funds with US$1 billion-plus, and that's resulting in higher prices. But in the middle market there are still relatively attractive prices."

The firm also values the maturity of the LatAm market and its seasoned managers who know how to handle crises and downturns, he says.

"We think our approach and that of some of our competitors is interesting as a first step into the region. With a fund of funds, you can get a diversified portfolio of 5 to 10 PE investments in the region, learn the region, and then make direct commitments down the road."

— Chris Bruneau, Executive Director, 57 Stars

"The PE markets in Latin America are more mature than in other places, compared, for example, to the current version of the Chinese PE market, which is quite young. LatAm had it in early 1990s — not all went well — but those who survived the 'nuclear winter' of Latin American PE are doing well. There are GPs that have gone through good times and bad times, while the Chinese haven't seen bad times yet."

As institutional investors enter LatAm, Mr. Bruneau thinks their initial approach will depend largely on their own resources. Investors with larger investment staffs and budgets may be able to put together strong portfolios themselves, relying on consultants, though they may run into difficulties regarding vintage years.

"For state pension plans and other institutional investors with a lot of capital and not a lot of human resources," he advises, "I would go through a fund of funds instead of picking 5 managers yourself; whereas some groups, such as large endowments, with bigger investment staffs, generally believe that they can put together a good portfolio themselves, relying on consultants."

The Second Wave

Duncan Littlejohn of Paul Capital on the Growing Secondary PE Market in LatAm and What It Means for Investors and Managers in the Region

Takeaways:

- As the LatAm primary PE market matures, a secondary market is emerging, with global secondary PE firms buying up portfolios with LatAm exposure.
- Secondary investments give investors quick exposure to assets and a differentiated risk portfolio.
- The secondary market in LatAm will give managers an interesting early-exit outlet, important for administrative and strategic purposes.

As the LatAm PE market matures and funds reach their allocation goals, a secondary market is slowly emerging. Global firms that specialize in buying PE on secondary markets are already buying portfolios with LatAm assets, resulting in interesting early exit opportunities for fund managers and new ways for global investors to gain exposure to the region.

Paul Capital is one of the most prominent secondary PE firms at work in the region, with offices in Sao Paulo and several LatAm assets under management. As Duncan Littlejohn, the firm's Managing Director in charge of LatAm investments, explains, Paul Capital gives liquidity to regional investors looking to exit a fund before the fund's natural liquidation, mostly by acquiring exposure to existing PE portfolios managed by legacy managers.

Fast Exposure

Secondary investments in Paul Capital's portfolios are distinct in several important ways from primary investments. One is that investors get more immediate exposure to assets.

"Investors who are building PE programs sometimes use the secondary market to accelerate the process and gain exposure to a diversified portfolio in a shorter period of time," Mr. Littlejohn says. "Secondary exposure is ultimately exposure to PE, and by getting into PE via the secondary market, you put your money to work a lot faster."

Investors also get a differentiated risk profile because of the timing of their investment relative to the manager's purchase of the asset.

"We have a visibility of the portfolio going in, which the primary investors don't have," Mr. Littlejohn explains. "Also, by definition, we invest at a point in time closer to when the portfolio begins making distributions, thereby mitigating the J-curve."

The nature of secondary investments dictates an approach to managers and assets that is fundamentally distinct from the approach taken by primary investors, with less emphasis on the manager than on the assets themselves.

"There are differences between what we look for and what the primary investors are looking for," Mr. Littlejohn explains. "They'll be looking at the manager, the team, the track record, while we look for funds that are already 75% invested, so there's more emphasis on the assets. We can talk to the manager about the investment thesis and current expectations, and then price the assets at a level that makes sense in terms of returns to our LPs. So while we obviously need to believe in the manager, we're really asset-buyers."

In addition to buying fund portfolios with legacy managers, Paul Capital

buys privately held portfolios not held in funds and then reformats them into newly formed fund vehicles; they call these purchases and re-formattings "secondary directs."

"It could be a group operating like a merchant doing club deals or a family office," Mr. Littlejohn says, giving an example of a secondary-direct context. "We would typically monetize the original investors (partially or completely) and/or provide some fresh capital for the portfolio companies, usually keeping the current manager as the GP."

Take a Load Off

In addition to offering investors an interesting entreé into LatAm PE, a mature secondary PE market also gives managers an early-exit outlet.

"If you're an endowment or pension fund that has a large PE program and you're investing in 5 or 10 funds a year," Mr. Littlejohn explains, "after 10 years you have 50 to 100 funds. The early funds have been largely divested, but invariably they still hold a few tail-end assets and they continue to be an administrative burden that is disproportionate to their NAV."

As many institutional investors are thinly staffed, he says, it makes more sense to have their manpower focused on more recent funds that are more relevant to their overall portfolio. "That's why a lot of PE makes its way to the secondary market, as a sort of administrative cleanup."

Managers may also want an early exit for purely strategic reasons, he says, for example, to get out of a certain geography or investment style. These strategic shifts also produce deal-flow for Paul Capital and secondary firms.

Slow Ripening

Mr. Littlejohn estimates that there are over a dozen global firms operating in this space, with total volume between US$20 billion and US$30 billion. The LatAm secondary market is still small, however, due to the relative lack of maturity of the primary market.

"The Latin American PE market began in the mid-1990s, died an ugly death in the late '90s, and came back to life around 2004-2005," Mr. Littlejohn recounts. "It's seen increasing amounts of fundraising in recent years, with 2011 being a record year, and a portion of that will become secondary opportunities over time. But you typically need about 5 years or more from every vintage year for any volume of secondaries to come to market. There's been deal-flow, but it's spotty. We have seen an increase and expect the trend to continue."

He believes the secondary market in LatAm will pick up when the large regional institutional funds get deeper into their investment cycles.

"Brazilian, Colombian, Peruvian and now Mexican pension funds are ramping up to their allocation targets, but they don't yet have much old PE that they're ready to recycle; they haven't become saturated yet with the administrative work of tracking these older and smaller investments."

He also believes large global banks will be selling portfolios through secondary markets in the coming years, including some with exposure to LatAm, as well as negotiating spin-outs of their captive PE teams.

Proving Their Worth

Timothy Cunningham of Touchstone Group on What Global Institutions are Looking for in LatAm Managers, as Well as the Strong Prospects for Brazilian Agriculture

As the LatAm private equity market grows and matures, it is vying increasingly for global institutional capital. These institutions are attracted to LatAm in large part because of the growth prospects in certain regions and sectors, but more importantly, they see a growing crop of managers with enough track record to prove their long-term viability.

"With many of the Latin American funds we're looking at, the track record for the first fund is well established, and for the second fund it's fairly well established; with the third fund, maybe not," says Timothy Cunningham, President of Touchstone Group, LLC, a PE placement agent that raises institutional capital for PE managers. "Increasingly, though, there's enough of a track record with some of these funds to put institutions at ease. We're seeing this at all levels of the market, both large and small."

For the last 5 years, Touchstone Group has sub-specialized in finding LatAm managers for its clients, most of them US and European institutions. With their more substantive track records and strong performances in recent years, these managers are better equipped to contend in an increasingly crowded global market.

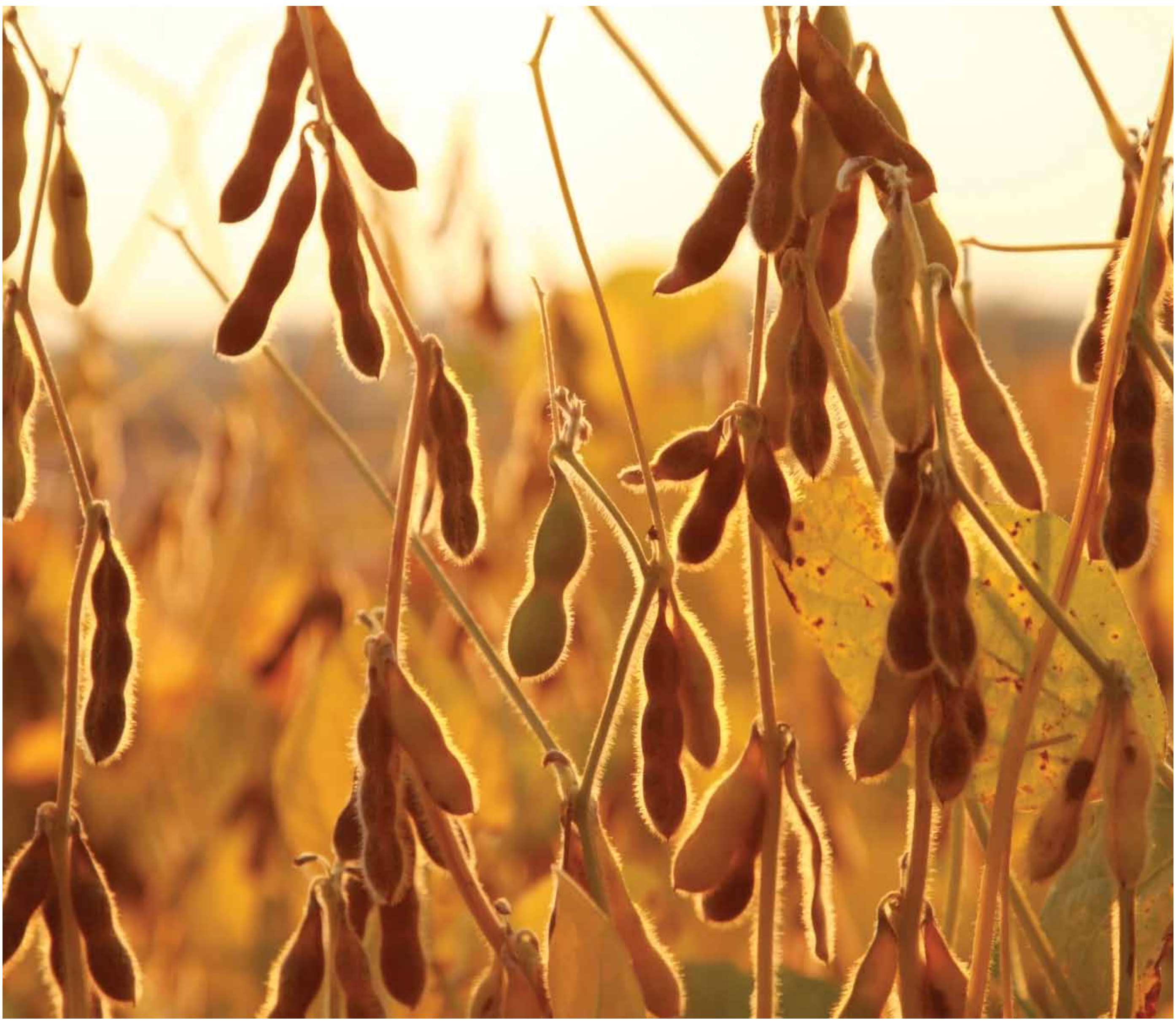
"Institutional commitments to private equity compete with each other on a global basis," Mr. Cunningham says. "Latin America has to compete with other regions of the world in getting capital commitments — including North America, Europe, Asia and, to a lesser extent, the so-called frontier markets."

Show Them What You've Got

Touchstone helps managers with every aspect of the fundraising process, including articulating their message; developing and refining marketing materials, such as presentations, PPMs and due diligence questionnaires; and assisting in the establishment of their online data room. Touchstone contacts the institutional LP community, arranges and attends meetings, then follows up through the subscription and commitment process. In all, it is a long-term process that goes on until the final closing.

Mr. Cunningham says that LatAm managers seeking institutional capital sometimes emphasize the wrong aspects of their offer, for example, by overemphasizing macro-related issues surrounding their investment theses.

"In Latin America," Mr. Cunningham explains, "if you're talking about the rise of the Brazilian consumer class, that's relevant, of course, but it's not the most important things to address with a prospective institutional investor. It's highly likely they already know the macro story; what they want to know is what makes you different, how do you do what you do, and why it matters to them. Focusing on macro won't result in as many orders as focusing on your team, your strategy and what differentiates



your firm from others in the market who are trying to attract institutional capital."

He adds that institutions are particularly attracted to managers who have already made a first close with an existing investor base. "It makes them more marketable. After all, if the investors who know the manager best are not willing to re-up, it's harder for new investors to be confident in making an investment commitment."

Double-Edged Sword

There is another respect in which overemphasizing macro indicators can be a mistake, Mr. Cunningham says, as the strength of a company should be evident irrespective of tailwinds.

"While it's true that the higher the overall GDP growth, the more exciting the economy will be in general, the most important element for private equity is growth in a specific portfolio company. Most PE strategies involve trying to stimulate portfolio company growth, which is obviously easier when the economy is growing and the wind is at your back. But nothing covers up problems in a company like growth and profit."

And while growth and profits can give a company breathing room to put effective management in place, he says, "in the short run, it can create its own problems and allow ineffective management to survive."

Splitting Up the Monolith

As institutions look to LatAm, Mr. Cunningham stresses that every country has its own story and set of circumstances. "They don't see it as a monolith," he says, describing the institutions' view of the region. "For the 1,200 to 1,400 global investors we market to, they see LatAm as a collection of countries, each of which has its own characteristics; they differentiate among countries and strategies, which can be either pan-regional or country-specific."

More importantly, within each country — and particularly within the large markets such as Brazil and Mexico — individual sectors themselves can be divided into sub-sectors with varying characteristics.

"In Latin America, if you're talking about the rise of the Brazilian consumer class, that's relevant, of course, but it's not the most important thing to address with a prospective institutional investor. It's highly likely they already know the macro story; what they want to know is what makes you different, how do you do what you do, and why it matters to them."

— Timothy Cunningham, — President, Touchstone Group

"If you try to generalize about a given sector, you'll find slow areas and fast areas. In agriculture, for example, there are sectors growing at 25% or 30%. Now, will that continue? Probably not, because it will bring in competition and that will slow the growth rate. Certain sub-sectors are maturing and growing quickly, while some are already mature and are slowing down."

Sub-sectors are also impacted by cyclical factors, he says. "If corn prices go up, the corn farmer is happy, but the chicken producer sees higher feed costs. So picking among the sub-sectors is key."

Thus, while the conventional wisdom is that the Brazilian economy has slowed and, therefore, the PE opportunities are weaker, Mr. Cunningham sees some very strong sub-sectors that continue to offer some of the best growth opportunities in the region.

Agriculture and agribusiness are 2 sectors where certain sub-sectors are outperforming, he says. Currently, Touchstone is representing one of the agribusiness's top value-chain investors, Aqua Capital Partners, a Sao Paulo-based firm that is targeting about 75% to 80% of its funds to Brazil, along with Paraguay, Uruguay and Chile.

"It's undeniable that we're going to continue to see Brazilian agriculture grow because of global agricultural supply and demand characteristics," Mr. Cunningham says. "Much of the world's focus has been on the demand side of the equation, with expanding middle classes in the developing world commanding a lot of attention. But it's the supply side that is really interesting because it is so constrained—by available arable land, water, technology, infrastructure and so forth."

He adds that one big story in Brazil is the massive agricultural area in the country's south-central region, known as the Cerrado, which has seen massive agricultural expansion over the last 25 years. "Continuing improvements in infrastructure and management talent have combined to make marginally productive land much more productive," he observes. "So I'm bullish on Brazilian agriculture. It's obvious to anyone who follows global agriculture."

Brazil has a modest crowd funding scene, with less than a dozen famous websites in the area. The amounts those websites are capable to process is estimated in less than a couple million dollars per year. Like anywhere else in the world, Brazilian crowd funding operations are focused in a few basic areas: artistic events, including movies; innovative business ventures (often related to technology and internet); and nonprofit initiatives, usually humanitarian in nature.

Adler Martins and Nuno F. Araújo

Crowd Funding Still Not a Replacement for Private Equity in Brazil

In a sense, a crowd funding website works as a mini stock exchange. Entrepreneurs will present their projects, and the website will act as a broker between the new venture and many possible investors or supporters.

The operation is not identical to an IPO, however. It is common for companies looking for crowd funding to offer benefits that are not related to equity or profits — for example, absolutely nothing (in case of humanitarian initiatives), the chance to obtain a small part in a future movie, or one or two units of the product that the company plans to develop.

The problem is, according to Brazilian law, the similarity with a regular public offer is too stark to disregard, which may trigger the application of several rules governing capital and financial markets.

This article will make a brief overview of the risks crowd funding websites face in Brazil, especially those dealing on the funding of new business ventures (as opposed to cultural and humanitarian projects).

Background: Brazil is scarred when it comes to public saving and capital markets.

Brazil has suffered heavily from lack of capital pools, extremely high inflation and currency devaluation during the 1900s.
A series of misfortunes has left a mark on Brazilian capital market rules and regulations, many of them drafted during the dictatorship era, notably 1960-1970.

In spite of moderate advancements in the last 20 years, Brazilian financial system is clearly out of sync with recent developments such as crowd funding.

Public offers and the Brazilian Stock Exchange Commission (CVM)

Brazilian Law n. 6.385, from 1976, regulates the stock markets. It defines public offers in a rather broad way, describing all usual financial instruments (bonds, equity and preferential shares) and including a general description of "any other bonds, or collective investment arrangements, when offered to the public."

It is widely recognized that any public offer that is related to any kind of return on invested capital is potentially regulated by Law. N. 6.385.

The same rules also describe that the Brazilian securities market shall be operated by a limited number of participants. Among them stock exchanges (such as Bovespa) and financial institutions, including banks and stock brokers.

Basically, all financial institutions are regulated by Law n. 4.595 from 1964 (as well as by many other legal rules), which requires them to obtain previous approval by the Brazilian Central Bank, before starting operations.

In consequence, there is no way an independent entity, such as a small website, would be able to publicly trade or offer securities without being previously registered with the Brazilian Central Bank.

Finally, normative instruction n. 400, from 2003, issued by the Brazilian Comissão de Valores Mobiliários - CVM (our Stock Exchange Commission) demands that any public offer be previously registered with CVM.

Therefore, it is clear that only a financial institution, formally approved by the Brazilian Central Bank, may request CVM's approval in order to, finally, be able to make public offers.

Since it seems that usual crowd funding websites are not allowed to operate in Brazil, at least not in the traditional way, one must inquire if there are any legal options for such ventures in Brazil.

The protection of public savings by the prohibition of raffles and similar practices

The route described above may seem a little disheartening. However, let's not forget that one of the crowd funding modalities does not deal specifically with equity in the new ventures, but with the purchase of products that will be developed in the future.

Unfortunately, this path also does not offer any shelter to crowd funding websites. Brazilian Law n. 5.768, from 1971, regulates the public placement of raffles or similar gambling competitions that are offered to the public.

The law says that any raffle or similar scheme that is publicly offered and that involves previous collection of payment by a large pool of consumers must be previously approved by the government.

Penal sanctions

The practice of business or operations that are restricted to financial institutions is a crime in Brazil, as per Law n. 7.492 from 1986. Also, the company's directors may be held responsible for such behaviors.

Options for crowd funding websites

Since it seems that usual crowd funding websites are not allowed to operate in Brazil, at least not in the traditional way, one must inquire if there are any legal options for such ventures in Brazil.

One option that comes to mind is to establish them as not-for-profit organizations that organize raffles. This is because Law n. 5.768 does not prohibit the organization of raffles and similar competitions by churches, humanitarian organizations and other institutions that serve the public. Such institutions must obtain a previous declaration of public utility before being able to enjoy this benefit.

A second option would be to organize crowd funding websites merely as intermediaries of donations made from the public to a specific business venture. This arrangement is not ideal, though, because it would eliminate the possibility of equity ownership in the company. The donors would, at maximum, be entitled to a small gift from the company, in exchange for their donation.

A third option is for Brazilian crowd funding sites to be located abroad, in countries where the regulation of such small scale investments is less restricted. After the funds are acquired, the total amount could be invested in Brazil as foreign direct investment. This option, as all others, is also not perfect. The remittance of money abroad is difficult for the average Brazilian citizen, for example. Also, this kind of operation would allow only the ownership of equity in the future company, not the purchase of future products. We hope Brazilian regulation evolves to catch up with modern ways of funding new ventures. Before that, crowd funding in Brazil remains a gray area, with a lot of risks associated to it.

Author Biography

Adler Martins is a Law graduate from one of Brazil's greatest Law Schools: The Federal University of Minas Gerais (UFMG). He is also a MBA by Fundação Getúlio Vargas. Presently attending Masters Course credits (LLM) at Pontifical Catholic University of Minas Gerais and a Post Graduation Course in Financial Planning at São Paulo City University. He can speak English, Spanish, Portuguese, German and some Chinese (Mandarin). Adler has working experience in Argentina, Mexico, India, England, China and Dubai, aside from extensive experience in Brazil.

Nuno F. Araújo is Bachelor of Law, graduated in Brazil, he is specializing in International Law by CEDIN-MG, with a study focused on international business, international taxation, international family law. He has experience in relocation consulting, criminal, labor, administrative and public Brazilian Law. He lived in France and England and speaks French, English, Spanish and Portuguese.

New Law Regulating Capital Markets in Argentina

Javier Canosa

On November 29, 2012, the Argentine Congress passed a new law regulating all the relevant aspects of capital markets and public offerings, thus terminating former Law 17,811 that regulated the same issue. The executive branch promulgated the law on December 28, 2012. We will briefly analyze the main aspects of such a new law on capital markets and public offerings.

The law aims to promote access to the capital market for small and midsize companies, as well as the participation of small investors, trade unions, associations, corporate associations, professional organizations and public savings institutions.

The new law broadens the spectrum for participating in capital markets as it eliminates the requirement of being a shareholder in any of the exchanges of Argentina in order to be a broker. With the demutualization promoted by the law, anyone who wants to be a broker shall request the enrollment in the registry of the National Securities Commission (NSC). In addition, the law provides for the possibility for universities to participate as ratings agencies.

The law also encourages the creation of a federally integrated market through shared computer networking.

The NSC is the only regulatory body of public offerings of securities. The NSC, directly and immediately, regulates, supervises, inspects, monitors and punishes all legal persons who perform public offerings of securities and other instruments, and/or perform operations and activities under the scope of the law. The NSC also keeps records of such persons and grants, suspends and revokes their authorization to operate, as well as the authorization of markets and enrolled agents.

The law aims to promote access to the capital market for small and midsize companies, as well as the participation of small investors, trade unions, associations, corporate associations, professional organizations and public savings institutions.

All trading instruments comprising similar features to public offerings as defined by the law, shall be considered as such, and shall be under the scope of the rules of the NSC as well.

Public offerings of securities issued by foreign states must be authorized by the Executive Power, with the exception of member countries of the MERCOSUR, which shall perform public offerings on condition of reciprocity.

The NSC will be headed by a board of directors composed of 5 members appointed by the Executive Power. The Executive Power designates the president and the vice president of the board. The board of directors may delegate functions to the respective holders of the regional headquarters, with the exception of those relating to the revocation of authorizations.

One of the main controversial features of the law is the faculty of the NSC to declare null, void, irregular and with no effects legal acts of companies under the supervision of the NSC, without prior summary or the intervention of a court.

Moreover and in the same venue, when as a result of "surveys conducted," interests of minority shareholders and/or holders of securities subject to public offering are affected, the NSC may appoint supervisors with the power to veto resolutions adopted by the administrative bodies of the relevant company subject to intervention by the NSC. The NSC resolutions may only be appealed in unique instances before the President of the NSC.

For the same reasons, the NSC may also separate the administrative bodies of the relevant company for a maximum term of 180 days until the deficiencies found are regularized. The latter measure may be appealed in unique instances before the Minister of Economy and Public Finance.

Because of the features mentioned above, it has been said that this new law on capital markets actually promotes legal uncertainty over potential companies that want to trade their securities in the capital markets of Argentina. Furthermore, some state the possible unconstitutionality of these intervention regulations, where the right of defense may be compromised by the lack of summaries for the application of sanctions, and the possibility the NSC may declare void private corporate acts.

Also, the law permits the exchange of information protected by secrecy between the NSC, the Central Bank and the Superintendent of Insurance of the Nation, executed by formal requirement to each other, provided they are made by the highest authority of each entity.

By terms of the law, the NSC shall have an integral role in the control of the capital market, with an increased punitive capability, and the possibility of exchange of information with other entities of the state.

In relation with the legal regime of scriptural securities and book entry securities, the creation, issue, transfer or establishment of real rights, precautionary measures and any other affectation of real rights conferred by the securities, is held by annotation in special registers carried by the issuer, or designated agents, commercial banks or investments banks, and shall produce effects and will be effective against third parties from the date of registration.

The entity authorized to carry the registration of securities shall grant the holder proof of opening of the account and any movement registered in it. Each holder has the right to be given a record of the current state of the account, at any moment and at their expense. The issue of a proof implicates the blocking of the account to the effects of transmission of securities or constitution of real rights over them, for a period of 10 business days.

If the issue of the proof was performed for the applicant to attend meetings or to exercise voting rights, the account shall be blocked until the day after the celebration of the corresponding meeting. If the meeting, whichever the cause may be, is held on a different date, the issue of a new proof is required.

In relation to the jurisdiction applicable for the resolution of conflicts, federal trial courts may hear in the claims of implementation of fines and audit fees, search warrants for the fulfillment of the supervisory functions of the NSC, and the designation of NSC of co-managers and supervisors. Within the city of Buenos Aires, courts of first instance in federal administrative litigation have jurisdiction to hear such disputes. The Federal Chambers of Appeal may resolve the revision of sanctions imposed by the NSC, as declarations of irregularity and inefficiency for administrative purposes.

With the same aims of the law of encouraging the creation of a federally integrated market, on November 21, 2012 the Stock Exchange of Buenos Aires (BCBA) and the Stock Market of Buenos Aires (MERVAL) executed a Memorandum of Understanding for the creation of a new business entity in the form of a corporation — Sociedad Anónima — which in the future will function as the Federal Stock Exchange or shall have a similar name. The intention is to create a new national market that can meet the needs of all the regions of the nation.

The law was approved within the precincts of the Senate by 43 votes in favor and 19 against of the dissenting Unión Cívica Radical (UCR) and Partido Justicialista (PJ) in the presence of the Economy Minister, Hernan Lorenzino, and the President of the NSC, Alejandro Vanoli.

The NSC shall issue the regulation of the law within 180 days as from the date of the enactment of the law, that is to say, before May 2013. Such regulation shall provide rules and schedules for the adequacy of entities, stock markets and brokers.

The NSC shall establish guidelines regarding (i) the offer of exchange of shares and similar processes; (ii) the vote exercised by entities which hold shares on behalf of third parties, in trusts, deposit or other legal relations, when the respective agreements authorize such vote; and (iii) the public request of powers to ensure the right to full information of the investor.

The law will be in effect on January 27, 2013, with the exception of those provisions described above subject to regulation by the NSC.

Author Biography

Javier Canosa is a partner in the Buenos Aires firm Canosa Abogados. Javier's practice focuses on corporate law issues, advising several national and foreign companies in various corporate matters, including investment vehicles, corporate management, directors' duties and responsibilities, audits, risk detection and distribution, documents, policies and corporate contracts, and design and implementation of a suitable corporate form for each business.

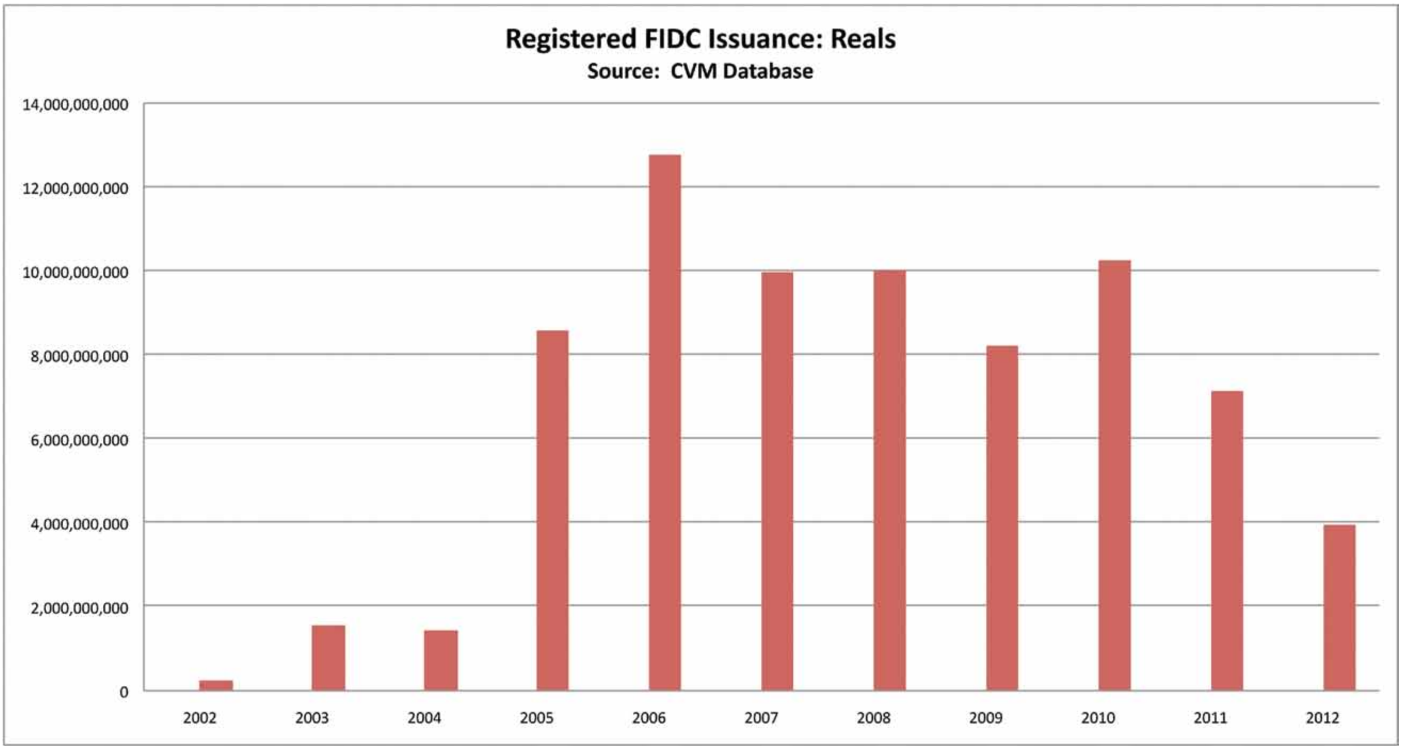
www.canosa.com.ar

Bad Practices Infect the ABS Market in Brazil: Do Not Blame the CVM

Vernon Hamilton Budinger, Principal Partner, Latin America Structured Finance Advisors, LLC

"When will Brazilian investors embrace structured finance?" The question came from a prospective international client last week. Investors have a right to be concerned; 2012 was not a year that the Brazilian asset-backed securities (ABS) market will remember fondly. Defaults have risen to record highs in many credit sectors, especially consumer loans. In addition, Brazil's central bank (Banco Central do Brasil - BCB) has had to rescue 7 banks since 2010. At least 5 of those banks failed because of fraud or other misdeeds involving ABS or collateralized securities: Banco Panamericano, Banco Morada, Banco Cruzerio do Sul (BCSul), and now Banco BVA(BVA).

At least 4 of the banks issued Fundos de Investimento in Direitos Creditórios (FIDCs) – the structure favored the most by Brazil's ABS market or Cédulas de Crédito Bancário (CCBs) that utilized commingled accounts. We wrote about the practice of commingling accounts and suggested alternative structures in an article in the May 2012 edition of Alternative Latin Investor. We revisit this feature again and examine the Comissão de Valores Mobiliários (CVM , Brazil's SEC) upcoming regulations to prohibit commingled accounts. The bottom line is that structuring firms and investors who do not adhere to best practices must accept part of the responsibility for the problems in Brazils' ABS market in Brazil.



Investor Credibility in Brazil's ABS Market Falls

The fall in investor credibility in Brazil's ABS markets has been surprising. It has only been a little over 2 years since BCSul was once considered such a strong credit that it issued debt in US dollars. In June it became the largest Latin American corporate bond default in 10 years according to a Bloomberg story posted by Boris Korby on September 14, 2012. While investors in BCSul's FIDCs are likely to get their money back, the last few months have been a wild ride for them. Investors in Banco BVA FIDCs may not be so lucky. On October 19th the BCB took over Banco BVA and problems with payments to the FIDCs began surfacing immediately.

We measure the damage to investor psyche by looking at issuance. FIDC issuance has declined precipitously since 2010, and 2012 marked the lowest issuance since 2004. The press has attributed much of the decline to confusion among Brazilian ABS issuers regarding CVM Instruction 489. Last year was the first full year that the instruction was put in effect.

The possible lack of demand from investors due to an increase of investor risk aversion has received little mention in the press. However, our discussions with Brazilian investors have been dominated by fears of about investing in FIDCs and we feel that this aversion could also be a factor in driving spreads wider and reducing issuance.

Who to Blame?

The CVM and the BCB have struggled to control the damage from a series of middle-market bank failures, all of which have involved some sort of structured finance product. The press has focused blame on the unscrupulous mid-tier bank operators, the CVM, the BCB, and issues with regulation and supervision.

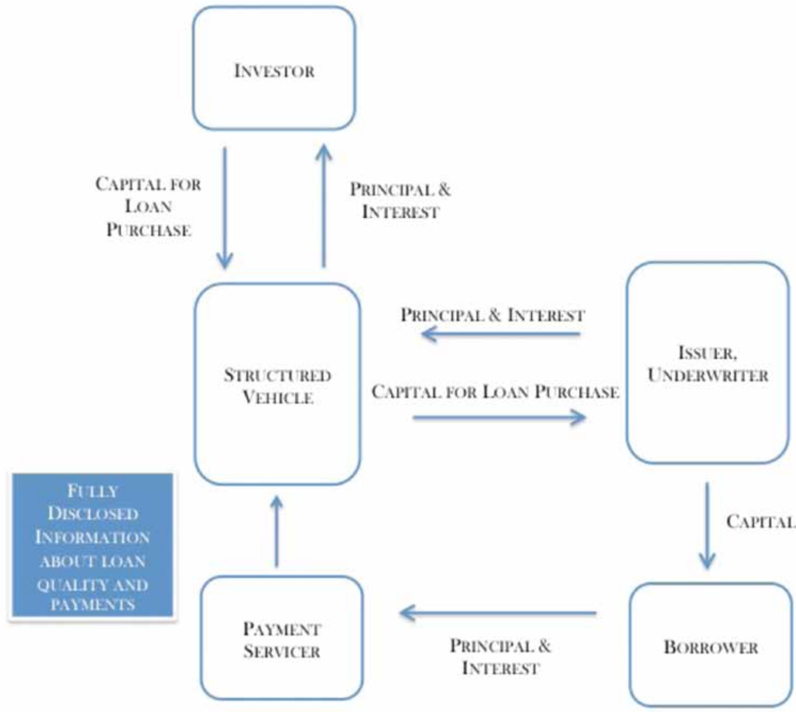
However, other players in the financial markets contributed to the embarrassing developments for structured finance in Brazil. There has been a trend in Brazil to use accounting practices that run contrary to every concept of good practice for ABS management. One of the most abused practices is commingling of cash from the FIDC with that of the bank or issuer.

Many FIDCs are structured so that FIDCs' cash payments are channeled through the issuer first. The issuer is then responsible for sorting out what cash goes to the FIDC. The argument in favor of this arrangement is that the issuer usually has a short timeframe to remit the money to the FIDC, generally 24 to 48 hours.

Over the past 4 or 5 years large issuers, credit agencies, auditors and the law firms associated with FIDCs and structured finance have convinced (pummeled into accepting) most investors that separate bank accounts for FIDCs are not necessary. The claim is that a 48 hour window is too small to commit fraud and that such illegal activity would be easily identified. These ill-advised commingling practices were implemented by the issuers and condoned by the law firms, accounting firms, and the rating agencies before being approved by the CVM.

The Solution – Just Do Not Commingle

In the May 2012 issue of Alternative Latin Investor, Jason Smith and I wrote a previously mentioned article criticizing this practice and suggesting alternatives. We focused on the case of Banco Morada, who is at the center of an ongoing fraud investigation regarding issuance of Cedulas de Crédito Bancário (CCBs – Bank Notes) by shell companies associated with Banco Morada. The central problem was that prepayments where misdirected and not applied to maturing the loans in the CCBs. The Banco Morada failure resulted in losses of millions of Brazilian reals for some of Brazil's biggest pension funds and one Swiss bank. This is our commentary.



The entity acting as agent, in this case Morada, is the same one that is receiving cash flows and payment information. Therefore this agent is the sole gatekeeper for information and funds for the investor, or the principal. It comes as no surprise that Morada was tempted by the large moral hazard to exploit the principal, the one party in the transaction who has equity or "skin in the game." Morada consequently perpetuated the shell game to mask shoddy underwriting and credit controls. Since Morada was never putting capital at risk, why not?

Best practices would dictate that the "servicer," or collector and workout agent for payments from borrowers should be a legally separate (or at least ring-fenced) entity that can provide full disclosure to the investors whom are the principals in this transaction. Since the very nature of government-sponsored consignados makes having a separate servicer difficult to implement (remember that these banks have special agreements with government institutions that allow them to collect on payrolls before the borrower has access to the funds) a sensible solution would be to ring-fence a separate box or create a strict firewall within the bank that receives the payments from borrowers.

With that small change, Figure 2 illustrates how borrower funds and payment information could flow directly to the investors and help keep the underwriter honest by having a "check" upon their flow of capital and information. Of course, they could still create value by selling these loans into the structure at more than their cost to originate, but their long-term incentive shifts away from payment fraudulence and towards underwriting loans.

The past year has shown us that even 24 hours is plenty of time for misdeeds. Banco BVA and its FIDCs are the latest examples. According the article by Uqbar, "BVA FIDCs: Credit or Operational Risk" that was posted on its portal TLON on December 5th, the BCB intervened on October 19th, 2012 and took over Banco BVA. The bank operated 5 FDICs: Multisetorial Open

The fall in investor credibility in Brazil's ABS markets has been surprising. It has only been a little over 2 years since BCSul was once considered such a strong credit that it issued debt in US dollars. In June it became the largest Latin American corporate bond default in 10 years.

Victory (Victory), FDIC Multisetorial BVA Master (Master), FDIC Multisetorial BVA Master II (Master II), the FDIC Multisetorial BVA Master III (Master III) and FIDC Multisetorial Italy (Italy).

Uqbar reported that Austin Ratings downgraded the cotas of 3 of the FIDCs on October 11th and placed the funds on negative credit watch. Master II and III had their cotas downgraded by 5 levels, from brAA(sf) to brBBB(sf). The Brazilian credit agency cited the high level of late payments in the portfolios as the prime reason for taking such drastic action.

Uqbar then reports that S&P put the funds on negative credit watch a few hours after the intervention because of operational problems in the FIDCs that could increase with the BCB's seizure of BVA. Unlike the Austin report, the S&P report noted that there was a decrease in the payments collected, but did not attribute the reduction to the late payments in the credit portfolio. In addition, S&P noted that the magnitude of the problem and the nearly simultaneous timing of the late payments suggested the existence of operational problems associated the collection agent (surprise, BVA was the collection agent).

The story continues when the cota holders of FIDC Italia petitioned BRL Trust DTVM, administrator of the FIDC, to clarify the efforts being adopted by BVA to collect the late payments (Note: According to CVM Instruction 356, the custodian should be in charge of collections in a FIDC). Uqbar pieces together the parts of the puzzle to conclude that BVA was misdirecting payments from loans in the FIDC to cover its cash flow needs in other parts of the bank. The diverted payments had been reported as late payments or defaults.

Uqbar reports that this Banco BVA's commingling arrangement is well known in the Brazilian market. In Banco BVA's case, it was justified by a stipulation that the bank had to transfer the funds within 24 hours.

Banco BVA and Banco Morado were not the only banks to abuse commingling privileges. BC Sul also joined the party according to Moody's. The rating agency reports that BC Sul "stopped transferring cash flows belonging to one of its securitizations (FIDC BC Sul Verax II) to the FIDC's custodian following the bank's liquidation" on page 8 in their report "Latin America Securitization: Outlook 2013."

CVM to the Rescue - New Regulations to Prohibit Commingling

But fear not, after 5 failures in less than 2 years, the CVM plans to issue a new set of "normas" or regulations to eliminate the practice of commingling of FIDC funds. They will require FIDCs to set up separate bank accounts for receiving payments. Moody's reports that the "sellers will no longer be able to commingle cash belonging to the securitization with their own accounts."

The rules were available for comment from May 2012 to September 2012 and should be issued early in 2013. Once again, we heard the same contorted views from the banks and associated legal and accounting experts as to why the CVM should not pass these regulations. Most of the rating agencies seem to have learned the lesson and are now quietly supporting the new standards.

The moral of the story is that the CVM and the regulators cannot catch every problem. The new CVM regulations should help restore confidence in the market. However, investors could help police the market by avoiding structures that do not adhere to best practices. This means not investing in deals that deviate from best practices even though prestigious law firms or accountants have put their stamp of approval on features. Investors should only invest in structures that utilize pure true sale and where the sponsors of the structure participate in a form that motivates a proper principal-agent relationship. Various market-sponsored entities, such as the Associação das Entidades dos Mercados Financeiros e de Capitais (ANBIMA), could issue a code of conduct that sets standards for the market based on best practices.

Author Biography

Vernon Hamilton, principal partner of LatAm Structured Finance is an investment advisor specializing in Latin American asset-backed securities. We use our proprietary technology and experience to identify unique investment opportunities and to protect our clients from risks embedded in complex structures. Vernon Budinger is an investment professional and a CFA with more than 28 years of experience. Prior to forming LatAm Structured Finance, Vernon worked at Western Asset Management and spent the last 3 years working for Western in Brazil where he evaluated Brazilian structured finance.

Who's Competing for Power in 2013?

Provided by LatinNews

There are a number of key electoral tests in Latin America during 2013, including presidential elections in Ecuador (17 February), Paraguay (21 April), Honduras (10 November) and Chile (17 November). In addition, there are mid-term elections in Argentina (October) and municipal elections in Venezuela (26 May). In the Caribbean, there are general elections in Grenada (19 February), Barbados (by May and the Cayman Islands (22 May).

Ecuador: President Rafael Correa (Alianza País - AP) is looking to make history by seeking to secure a second consecutive re-election in order to become Ecuador's longest-serving president. Given that AP remains the leading political force in the country, and opinion polls put support for him at over 50%, Correa will win. Yet a political novice, Guillermo Lasso, who is a former banker, has injected life into an otherwise stale campaign by criticizing the Correa administration's mismanagement of the country's finances and accusing it of insufficient social spending. Lasso has declared that if elected he would substantially increase the government's cash transfer scheme for the poor (BDH). This allowed Lasso, who is running for the Creo movement, to gain overnight popularity.

Paraguay: The upcoming presidential and legislative elections in Paraguay follow the impeachment of former President Fernando Lugo (2008-2012) by a hostile Congress in June 2012. Lugo, who managed to unite the Left as well as forge an alliance with the center-right Partido Liberal Radical Auténtico (PLRA) in the last general elections to unseat the Asociación Nacional Republicana- Partido Colorado (ANR-PC), which had remained in power for over 60 years, was unable to stay in power after losing the PLRA's support 4 years into his 5-year term. The PLRA retained power with Lugo's Vice President (now President) Federico Franco, and it has opted against re-forging a wide-based alliance with the Left, refusing to enter into an electoral alliance with Frente Guasú (FG), the leftist coalition of parties that has coalesced around Lugo. Instead the PLRA's presidential candidate, Efraín Alegre, has sought to seal an alliance with the moderate Left by choosing Rafael Filizzola, the leader of the small Partido Democrático Progresista (PDP) as his running mate. While Alegre and Filizzola are in front in many polls, they are not the favorites to win the presidential contest. That label is currently held by Horacio Cartes, the ANR-PC's presidential candidate. The ANR-PC has the largest party affiliation in the country and has the only truly national party machinery.

Honduras: The main contenders for the presidency are Juan Orlando Hernández, Partido Nacional (PN); Mauricio Villeda, Partido Liberal (PL); Xiomara Castro, Partido Libertad y Refundación (Libre); Salvador Nasralla, Partido Anticorrupción (PAC); and General Romeo Vásquez Velásquez, Alianza Patriótica Hondureña (APH).

The problems besetting the PL after the June 2009 coup meant that the PN was the only real choice in 2009. The PL has yet to get over its internal problems, making the PN a strong bet to retain power for a second term. However, the PN might also struggle to present a united front moving forward amid the intense animosity between the rival factions led by Hernández and Ricardo Álvarez. This could benefit Castro. However, she is adamant that if she were to win she would convene a national constituent assembly. This might stop her winning over moderates keen to avoid a repeat of the crisis which culminated in Zelaya's removal from power for attempting to convene a constituent assembly.

Chile: The main contenders are: the ruling Coalición por el Cambio of President Sebastián Piñera (comprising his right-of-center Renovación Nacional [RN] and the traditional right-wing Unión Demócrata Independiente [UDI]) and the quadripartite left-wing opposition Concertación. Neither coalition has yet named their candidates, although the UDI has officially proclaimed Laurence Golborne, the Right's most popular political figure and until recently Piñera's star public works minister, as its pre-candidate. Other contenders include Marco Enríquez-Ominami (Partido Progresista de Chile, PRO) and Franco Parisi (independent).

According to the latest poll by the pollster Centro de Estudios de la Realidad Contemporanea (Cerc), Golborne had 76% approval shortly before he stepped down for the presidential race. He will face another star former minister (defense) Andrés Allamand, pre-candidate for the RN, who recorded an approval of 73% at the time of his departure.

A key question is whether the highly popular former president, Michelle Bachelet (2006-2010) (of the Concertación's Partido Socialista - PS) will run. Bachelet tops the polls with 43% compared with 13% for Golborne, 7% for Enríquez-Ominami; 6% for Farisi, and 6% for Allamand.

latinnews.com

Company Biography

LatinNews has been the source of political, economic, security and strategic analysis since 1967. LatinNews serves as a comprehensive intelligence resource on 33 countries in Central America, Latin America and the Caribbean. A broad portfolio of publications and a searchable online database provide subscribers with analysis on key events. LatinNews Consulting also provides bespoke research and business intelligence for clients with interests in the region, drawing on an unrivaled network of in-country correspondents, contacts and subject-experts to deliver client-focused intelligence for businesses and governments. www.latinnews.com

Why isn't Human Capital a Foreign Policy Issue?

Gabriel Sanchez Zinny

There appears to be a growing consensus in US and Latin American circles that our diplomatic relationship has not been very dynamic over the past decade—with hopes that the re-election of President Obama could finally occasion the real hemispheric dialogue that he said was his priority at the beginning of his first term. But this kind of thinking is clearly coming from a US perspective, since many Latin American societies are asking themselves why they would want to engage more with the United States. Indeed, most are trying to diversify their political and economic portfolios.

So what are the major issues in the hemispheric relationship? Certainly, they include democracy promotion and human rights, citizen and border security, and trade. There is also new integration efforts such as the Trans-Pacific Partnership and the Pacific Alliance, as well as the Obama administration's "Pathways to Prosperity" program, which seeks to promote social inclusion through support for small business and human capital development.

Security and trafficking issues are key to the sustainability of the region, and both the United States and Latin America have a lot at stake in the outcome. But I would argue that the same applies to trade and economic growth, even though it has been less visible on the diplomatic agenda. However, one of the most important issues—education, the human capital that is the foundation for all these topics, the basis and the long-term driver for many of them—is hardly addressed in the hemispheric dialogue.

Human capital is not only an essential factor for promoting economic growth, alleviating poverty and preventing drug consumption, but is also one where both North and South face challenges. In the Program for International Student Assessment (PISA) figures, the United States is at or below the OECD average in math, science and literacy, and the US graduation rate barely tops 75 percent. This, even though the United States is the country with the highest per capita spending on education—around $12,000 per student per year.

Latin American is doing even worse, perpetually in the bottom third of the international rankings. If the region wants to maintain its recent spurt of economic growth, it can only sustain it through increases in productivity, innovation and improved competitiveness. The basis of all that is better education.

Some recent State Department initiatives focus on education, like one signed with Brazilian President Dilma Rousseff, which will send 100,000 Brazilian students abroad, half of whom will come to study in the United States. Education is also addressed through USAID programs, and through the multilateral development community. However, it is an issue that deserves more attention in any diplomatic relationship, given that a well-educated society is a key asset for every country.

We are seeing already some of this in the policy and philanthropic communities. Initiatives like PREAL, Teach for America, the World Fund, and Junior Achievement are all promoting greater hemispheric dialogues and shared experiences around education. They are doing so through many different channels. Some are fundraising in the United States and investing in better teacher training in Latin America while others are connecting policymakers throughout the region to advance the conversation and share best practices from around the hemisphere. It is a good beginning – and diplomacy should follow that lead.

Author Biography

Gabriel Sanchez Zinney is the founder and Managing Director at Kuepa, leading blended learning company in America Latina, and partner at Blue Star Strategies. His previous experience includes development of health services, management of the implementation of new technologies in the education sector and directing the Argentina program for International Scholars at the Woodrow Wilson Center. Prior to Blue Star Strategies, he served as Vice President at Dutko Worldwide, in the areas of Foreign and U.S. Federal Affairs. Gabriel co-authored four books on education policy and is an opinion columnist in several Latin American newspapers. He also was a director at Edunexo.com, one of the first software companies to address the education sector in Latin America. Gabriel studied Economics at the University of San Andrés in Buenos Aires, Argentina and completed his Masters in Public Policy at Georgetown University in Washington, DC.

Brazilian Cyber Security

James Knight

"A few years ago the question was 'What's your China strategy?' Now the question is 'What's your Brazil strategy?'," says Yann de Vries, Managing Director and Co-Founder of Redpoint e.ventures (RPeV). The early-stage VC specialist raised US$130 million in July 2012 to create Brazil's first dedicated Silicon Valley fund. "It's the next frontier of growth, and we get solicited by corporates who want to get into the market." For a company that has already explored far beyond California to find the next generation of startups, Brazil is the next big thing.

Brazilians love to surf, and not only from the beaches of Rio. Internet penetration has doubled year-over-year for the last 4 years, and now about 43% of the country's 200 million-strong population has internet access, according to IBOPE Nielsen Online. The IT sector in Brazil generated US$11 billion in 2011, making it the world's 7th largest market and accounting for 4.5% of GDP.

While ICT is a broad church, one segment in particular shows huge potential for growth: cybersecurity. Silicon Valley has seen some red-hot takeover activity in this area in the last 2 years, but the Brazilian market has seen virtually no consolidation at all so far. As a result, VCs are excited by the prospect of placing a series of small bets on companies that will become the household names of the future. If just one of them grows enough to come on the radar of a domestic PE shop 2-3 years down the line, the strategy more than pays off. Alternatively, as in the US, over the next 5 years established local ICT firms will also look to acquire specialist players to fill the gaps in their own security portfolios.

Retail Behaviors

A key driver for cybersecurity growth in Brazil is the scale of the cybercrime problem. Norton/Symantec research estimates that a staggering 80% of Brazilian adults have been victims of cybercrime, and it cost the country US$8 billion in 2012. Huge online databases, available for just a few dollars, contain millions of bytes of data phished by hackers.

But getting the man on the street to think about online security is easier said than done.

The big multinationals — Norton/Symantec, McAfee and Kaspersky — have struggled trying to embed the model of paid-for software. However, Brazilian challenges are creating Brazilian solutions. Rio-based holding Xango Group was one of the first startups RPeV backed, with US$2.4 million of seed capital in mid-2010. Xango went to market with a free, cloud-based antivirus product, PSafe, in April 2011 and in 18 months it had 21 million users — 25% penetration of all active internet users in Brazil. They were attracted not only by the no-cost option, but by branding that was tailored to their cultural and linguistic preferences. PSafe launched in Spanish-speaking Latin America in November 2012 and already has more than 1 million subscribers.

System engineers were staggered by what they found. "Of the machines we touch, 86% are infected," says Marco DeMello, Xango Group CEO. "On average they have 3 infections, some have 20-30 trojans on them. I don't even know how they are using them."

"They have started looking to security as a more critical service, not just buying hardware and software but looking for someone to manage it and having someone to worry about compliance and setting up safe access to information..."

André Frederico

Pirated software plays a part in spreading viruses — many of the CD-ROMs containing programs such as Windows Office also come with pre-loaded trojans that hand over control over their computers to the cyber-

criminals the moment the software is loaded onto their machines.

"But they don't want to stop downloading illegal porn or illegal games," says DeMello. "They are not going to change their behavior. This product acts as a kind of shield."

Corporate challenges

Fighting cybercrime cost Brazilian businesses more than US$1 billion in 2011, according to a recent study by PricewaterhouseCoopers. One estimate has more than 95% of all malware written in Brazil targeting the financial services sector. This has meant that attractive margins have been available in the lucrative "managed security services" sector, where corporate clients, especially banks, have spent billions beefing up their defensive and offensive cybersecurity capabilities.

TIVIT is at a different stage of the life cycle than Xango; it is one of the domestic behemoths that combined local IT and business process management companies as early as 2007. Less than 15 years old, it was originally backed by locally based equity shops Patria and Nototorim New Ventures. At its IPO in May 2010, Apax acquired a 54% share at R$18.1/share, valuing the company at approximately USD$1 billion. At the start of 2012 it took it off the Novo Mercado, increasing its holding to 97%.

The bulk of the firm's R$1.5 billion in revenues in 2012 came from providing "mission-critical services" to corporate clients, some of Brazil's largest companies, who rely on round-the-clock, fail-safe IT provision. Credit card companies in particular have experienced rapid growth as the roll out of access to financial services for Brazil's lower-middle and upper-working classes has taken place.

To respond to a dynamic, constant threat, these kinds of corporate customers are looking for a more integrated service than simply virus protection or IP tracking. "They have started looking to security as a more critical service, not just buying hardware and software but looking for someone to manage it and having someone to worry about compliance and setting up safe access to information," says André Frederico, Director of Corporate Development. "This

Infrastructure upgrades to roads, railways and ports will also require IT solutions that maintain mission-critical services and adequately protect data.

level of governance and management of security has evolved a lot."

The manufacturing and agricultural industries want to learn from the experience of the banking sector to secure their own data. In addition, small and medium-sized businesses, that at the moment have no budget line for IT security, are desperate for a more economic solution. Frederico cites the example of a retail company, or a construction firm, with a much lower IT budget, that might be still be in Brazil's top 1,500 company bracket in terms of size and revenues. "They don't have the same level of mission-critical services. However, we recently built a cloud-based offering relating to this type of client."

Government threats

State and federal governments are huge purchasers of IT: some estimates put their marketshare at 35%. The country's voting system has run successfully on electronic systems since 1996. In 2011, the wishes of 140 million registered voters were known within 3 hours. In the same year, 25 million electronic tax declarations were filed in Brazil's notoriously complex fiscal system.

The Economist Intelligence Unit's Cyber Power Index, a benchmark of the ability of G20 countries to withstand cyber attacks and deploy the digital infrastructure necessary for a productive and secure economy, ranks Brazil 10th. China, Russia and India stand at 13th, 14th and 17th respectively. "Federal and state-level authorities have only recently started to pay attention to security as a budgetary requirement. They are spending on it, and concerned about it," says DeMello.

As well they should. Governments have more to worry about. Not only are cyber criminals hungry for more data on citizens — social security numbers, medical records, pension arrangements — but foreign states hungry for secrets, and rogue organizations keen to embarrass those in power. The Department of Information Security and Communications (DSIC), based within the Brazilian Presidency, and which monitors attempts to compromise government

IT infrastructure, is seeing a "significant increase" in the appearance of malware, botnets and denial of server (DdoS) attacks.

"I've seen a shift in mind-set in the last 12 months," says Xango's DeMello. "Anonymous (a group of hackers) have shown a huge flashlight on the vulnerability of government networks. Governments also need to be concerned about cyber-espionage."

In the coming years, Brazil plans to implement smart-grid technologies to improve power distribution in its notoriously shaky energy sector. Infrastructure upgrades to roads, railways and ports will also require IT solutions that maintain mission-critical services and adequately protect data. The 2014 World Cup and 2016 Rio Olympics will require ticketing, transport and event management IT, requiring an even greater level of integration and security. While the World Cup IT infrastructure is already fairly joined-up, plans are already being drawn up for the Olympic networking infrastructure to be as isolated as possible, with specific "touch points" that will be heavily protected, to try and limit attacks.

A traditionally lax legal and regulatory environment for cybercrime has also now changed. At the end of 2012, President Dilma Rousseff finally signed into law 2 much-delayed measures that finally incorporated into the penal code computer hacking, theft of passwords or emails, and webpage attacks as crimes, punishable by prison sentences in serious cases.

While this bolsters recognition of the problem, solutions will have to come in the form of public-private collaborations. One such example was announced in 2010 between cloud-based specialist Panda Security and the Brazilian Army's Cyber-Warfare Centre. The bespoke project included development of an application to track attacks on the army's IT network and trace the IPs from which they came, although the company's 2-year contract was not renewed, eventually going to a Brazilian firm.

"What I know is that the Brazilian government is looking for solutions to be developed. And as far as I know, they are working with private companies," says Panda Security Brazil's Director General Ricardo Bachert.

All players stress the need for foreigners to team up with a reliable local partner that has cultural and market understanding. However, a combination of reckless retail behavior, a corporate sector demanding evermore innovative solutions and the government's need for solutions on time-sensitive projects means that cybersecurity in Brazil offers some rich pickings in the future. And the inevitable growth of cloud-based computing and smartphone technologies will require the development of new products and services to counter new threats.

Author Biography

James Knight is a LatAm-based journalist and consultant with 10 years' experience of working in and with emerging market countries. He is Director of Pionero Partners, a locally based risk and strategic advisory consultancy serving international clients. Prior to his current role he acted as an advisor to Chinese clients on various LatAm projects and previously worked at Barclays Bank Plc. He has acted as a strategic consultant to the World Bank and the United Nations, while his investigative and analytical skills were honed with journalism for Reuters, The Economist, Africa Confidential and BBC Online covering business, investment and conflict. He holds an undergraduate degree from Cambridge University.

www.pioneropartners.com