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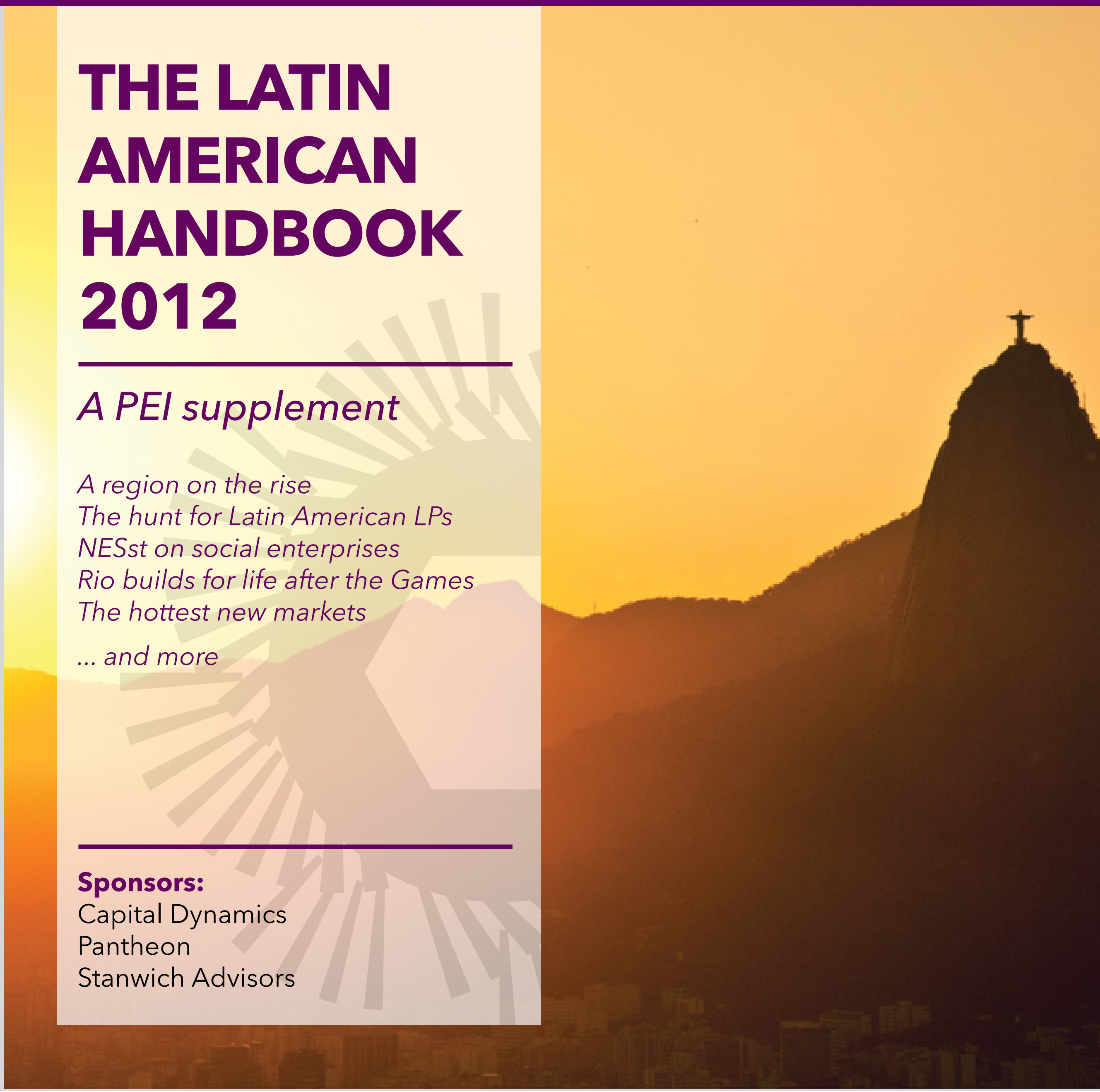

THE LATIN AMERICAN HANDBOOK 2012

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EXPERT COMMENTARY **CAPITAL DYNAMICS**

Paving the way for fund of funds

Brazil's growing ranks of institutional and high-net-worth investors should look to fund of funds for diversification and efficiency, writes Marcelo Moraes, Capital Dynamics' head of Brazil

The Brazilian private equity investment environment has shown a marked improvement since 2003, even in comparison with other 'BRIC' countries. Along with rapid economic growth, one of the catalysts for the private equity industry surge was the release of a robust regulatory framework for private equity investments. In particular, the Brazilian Securities Commission's (CVM) 'instruction 391' in 2003 paved the way for institutional investors to invest in all private equity fund strategies. Prior to this, under CVM's 'instruction 209', only venture capital had a proper regulatory framework. Brazil is now considering merging both regulations, which should further improve the environment for the private equity industry.

Private equity firms are becoming increasingly sought-after partners by Brazilian companies, especially by small and midsize companies. These companies benefit from the market, operational, and financial knowledge of private equity managers that, in particular, help companies obtain financing with more favourable conditions. One obvious point in favour of Brazilian investments in contrast with other emerging markets, cited by investors, is the issuance of financial statements according to IFRS guidelines, which offers much greater transparency. Furthermore, the stable democratic political system in Brazil, in contrast with the relative instability in other BRIC countries, should support the stronger long-term growth of the private equity industry.

Moraes: *fund of funds a solution for Brazilian LPs*

> *"Brazilian LPs want to partner/co-invest with foreign LPs"*

In the short term, three key milestones in Brazil, the 2014 World Cup, the 2016 Olympic Games, and recent developments in the oil and gas industry, together with the strong demand for commodities, will enhance local investment opportunities in all sectors. Competitive advantage in commodity sectors such as iron ore, oil and gas, ethanol, agri-business, chemicals, and a gap between the larger producers and their supply-chain companies, due to supplier's lack of financial and governance knowledge, provides attractive investment opportunities. It also leads to job creation, purchasing power enhancement and internal consumer market growth, which in turn creates investment opportunities in consumer product sectors, which include, credit, insurance, education, health care and non-durables.

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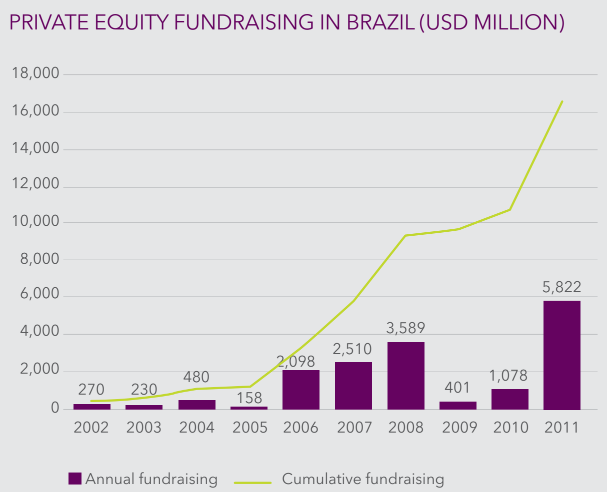

Source: Capital Dynamics based on Emerging Markets Private Equity Association and Thomson Reuters data

OPPORTUNITY AMID GLOBAL TURMOIL

Brazil continues to demonstrate great resilience to the global economic downturn. Despite some slowdown, Brazil was on pace to achieve an annual growth rate of 2.9 percent in 2011, compared with 1.6 percent in advanced countries, according to IMF estimates from January 2012. Unlike many other emerging economies, Brazil has a relatively low dependence on commodities and natural resources, which accounted for 3 percent of the gross domestic output in 2010, according to IBGE statistics. The domestic market is the major engine of GDP growth, with domestic consumption accounting for about 80 percent of GDP in the third quarter of 2011. Furthermore, indebtedness remains relatively low compared with other countries. Net public debt stood at 39.1 percent as a percentage of GDP in 2010, and declined to 36.5 percent in December 2011, according to the latest publication of the Central Bank of Brazil. More importantly, Brazil has zero external net debt. The high confidence of international investors reflected the continuous increase of foreign direct investments, even during the economic crisis. Standard and Poor's granted Brazil investment grade status in 2008 and in November last year, upgraded the country to "Stable Outlook" despite the global economic slowdown. The spreads on government and corporate bonds remain at historical lows despite recent high market volatility. All of this creates a path for foreign investors and GPs to invest in Brazil.

From a local investor's perspective, the interest rate decrease, combined with the high concentration in fixed income products (approximately 60 percent of consolidated pension fund assets and 45 percent of private market fund assets), and the lack of assets, as evidenced by the BM&FBovespa Brazilian stock exchange, with only 470 listed companies, creates the need for portfolio diversification. The majority of pension funds, family offices and high-net-worth investors have not been exposed to private equity yet. According to the Brazilian Pension Fund Association (ABRAPP), the average allocation of Brazilian pension funds to private equity in 2011 was approximately 2.5 percent, and this number was vastly skewed by a limited number of large pension funds active in private equity.

The majority of pension funds have an allocation close to zero, and for some of them, the amount of money available for private equity does not allow a satisfactory allocation strategy. Brazilian LPs want to partner/co-invest with foreign LPs. They also value a global GP's experience and deal exposure, as well as their investment process knowledge. For these reasons, the path is enhanced for foreign investors and GPs to do business in Brazil.

THE ROLE OF FUND OF FUNDS

Given the private equity investment environment described above, the relatively high investment minimums that fund managers generally require make it challenging for a small institutional or high-net-worth investor to gain sufficient diversification. By combining the investments of many medium size investors, the fund of funds provides a potentially cost-effective solution to the challenges of administration, information, access and diversification. Also, the "efficient frontier model" demonstrates how adding high performing assets, such as private equity, to a portfolio of public equity and fixed-income securities improves the portfolio's performance. There are six key benefit areas of fund of funds:

1. Diversification

Currently, the average Brazilian portfolio allocation is dominated by fixed income securities. The returns of such investments have fallen as a result of declining interest rates. In a fast growing country such as Brazil, equities, and to a greater extent, private equities, have a higher potential to be a major source of returns. Investors seeking greater returns on a risk adjusted basis can achieve this through fund of funds.

EXPERT COMMENTARY **CAPITAL DYNAMICS**

Prudent investment in private equity requires an allocation program through which the investor will allocate capital into 10 to 20 funds. Investors lacking sufficient capital to participate in so many funds, gain from the diversification achieved by a fund of funds despite small allocations. According to our quantitative analysis based on Monte Carlo simulation, the risk of losing capital is much reduced when investing through fund of funds compared with over-concentrated direct fund portfolios. Selection risk is greater in emerging private equity landscapes such as Brazil, where there are a smaller number of experienced GPs with proven track records when compared with developed private equity markets.

2. Reduction of some investment inhibition aspects

The J-curve effect and the lack of liquidity have been extensively discussed as hurdles to private equity investing. In Brazil, investors are even more sensitive to these special features of direct private equity investing. For example, private equity investments by Brazilian pension funds are exposed to greater scrutiny by their internal committees, as they still have great difficulty in justifying the downside of the curve. Fund of funds that include an allocation to secondaries can be beneficial in reducing this J-curve effect, which is important for Brazilian pension funds. This is achieved by investing in different fund vintages and strategies, whilst investment in a private equity secondary opportunity can also improve liquidity.

3. Investment expertise and experience

Manager selection has a more important bearing on an investor′s ultimate performance in the private equity market than in the public equity market. The majority of institutional investors in Brazil are new to this asset class, and therefore face a difficult task in selecting appropriate investment opportunities. Such investors can work around this by investing with an experienced fund of funds manager. Fund of funds usually have built-in rigorous evaluation processes to; analyse the strategy of the fund manager, analyse investment performance, assess team qualifications, validate the market strategy, and make sure that fund terms are well structured. Fund of funds are also often in a better position to negotiate better fund terms than individual investors can themselves. In addition, fund of funds usually have better access to industry data and due diligence materials from existing and prospective managers which provide a more robust information set to better judge, compare, and analyse prospective investment opportunities. Another aspect is the access to better performing managers, which is of great importance in Brazil. Fund of funds have often built industry connections that can help to secure desired allocations in oversubscribed Funds. Furthermore, a potential lack of expertise in specific areas such as venture capital, growth capital or international private equity, make funds of funds an interesting option to fill such a gap.

4. Governance and transparency

Investment in private equity is time-consuming because it requires not only extensive due diligence, negotiation, legal and tax analysis, but also, compliance, investment monitoring and reporting. Many institutional and high-net-worth investors in developed countries, and even more so in Brazil, lack the administrative and portfolio management skills and resources required. Moreover, the knowledge of local specifics is vital for private equity investments in Brazil. An optimal solution for these investors is to outsource these tasks to fund of funds. Such vehicles offer these services with governance, transparency, and on a more cost-effective basis than building an internal private equity investment and administration unit. As private equity is a growing industry in Brazil, these types of services can be costly or difficult to attain, hence another reason to invest in a fund of funds.

5. Investment scaling up or scaling down

Smaller institutions and high-net-worth investors have difficulty meeting minimum investment requirements. Larger investors have difficulty making investments in venture and growth capital funds due to the small size of these funds. Fund of funds can mitigate such size differences by helping an investor to "scale up" or "scale down".

6. Support a secondary market for private equity funds

Although the secondary market is still nascent in Brazil, fund of funds are well positioned to profit from this emerging opportunity to mitigate the J-curve and enhance returns.

In summary, fund of funds are an efficient way for investors to enter the private equity asset class and build a diversified portfolio in a cost effective way. As such, fund of funds allow a wider group of investors to participate in this exciting asset class. ■