BDO KNOWS INTERNATIONAL PRIVATE EQUITY:

SPOTLIGHT ON BRAZIL

Fred Campos, Managing Director of Transaction Advisory Services at BDO USA, sat down with **Romina Lima**, Senior Corporate Finance and M&A Manager, and **Vinicius Evangelinos**, Transaction Services Manager, both of BDO Brazil, to discuss the latest PE trends in the region. Here are some insights from their conversation.

Fred Campos

Romina Lima

Vinicius Evangelinos

Brazil has been navigating an economic downturn for more than a year now, and between the potential impeachment of President Dilma Rousseff and the continuing global commodity price slump, it appears that the pain is expected to continue. What does this mean for private equity investment? What trends are you seeing?

The current economic climate has been, no doubt, extremely challenging for Brazil. Since the second half of 2014, we've watched our GDP contract considerably, and both inflation and unemployment are hovering near 10 percent. Global demand is down for some of Brazil's key exports, such as sugar, meat, tobacco, coffee and soy, and the disastrously low global oil prices are not helping. It's growing increasingly difficult to access debt financing, and all three credit rating agencies have downgraded Brazil's sovereign debt.

However difficult these market conditions may be for the country overall, we are seeing significant pockets of opportunity for PE investors, who stand to benefit from cooling prices, lower valuations, and the continued impact of changes in the Brazilian government. Industries implicated in corruption scandals—real estate, construction, and oil and gas—are putting assets up for sale at low prices, and PE firms are seeing opportunities to serve untapped, cash-hungry markets.

As always, investors are keeping an eye on changes in government leadership. Anytime we see political turmoil, the possibility exists that a new government may introduce positive reforms to improve access to the markets. And right now, it seems that investors are feeling fairly hopeful: The stock markets have rallied and the Brazilian Real has strengthened as the likelihood of Rousseff's impeachment has increased.

What this means for PE investment, ultimately, is while investors are cautious about the political and economic forces at play, they are optimistic that Brazil will continue to provide strategic opportunities for them to deploy their dry powder.

Assuming Brazil remains an attractive target for investors, what industries do you think will be of most interest to investors looking into Brazil?

Mergermarket data shows that, in Q1 2016, the financial services and consumer discretionary industries saw the greatest transaction activity, followed by industrials and informational technology. Consumer staples also accounted for about 12 percent of M&A deals last quarter. Though consumers are feeling the pain of the recession, Brazil boasts a population of 200 million—making it a natural target for consumer-focused businesses. Over the past few years, a rapidly-growing middle class has created increased purchasing power and sizable demand for goods. Consumer goods companies are taking notice of this shift, as are funds playing in that sector. We may also see some tangential growth in the technology sector as a result of the growing consumer base, with credit card processing, mobile payments and online gaming specifically ripe for PE investment in the coming months.

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For energy, mining and utilities to remain ripe for investment, there would need to be a large investment in infrastructure, specifically roads and pipelines—commitments the new government has stated will be a priority in an effort to curb critical energy shortages nationwide. But oil prices remain depressed and signals of recovery are scant. We may expect to see PE funds step in once the industry begins to stabilize, but before valuations start to creep back up. The difficult part is, of course, knowing when we will reach that point.

But the oil price slump may actually be good news for the manufacturing and industrials sectors, which are benefitting from lower energy and commodity costs. PE firms may find opportunities for significant growth in this area in the years to come, particularly if we see more privatized infrastructure projects requiring the resources and expertise of manufacturers.

Finally, we have started to see some limited interest in the healthcare sector as a result of last year's legislation lifting Brazil's long-standing ban on foreign investment in the industry. The healthcare industry accounts for about one-tenth of Brazil's GDP but is in dire need of funds to update its aging infrastructure and to grow its ranks of care providers. Furthermore, the industry is highly fragmented, which presents another opportunity for private equity firms to consolidate through add-on acquisitions that will help drive up value at exit. But the current recession and political uncertainty may be having a cooling effect on investment right now, with investors holding out until some of the volatility settles to thoroughly evaluate the sector and the opportunities it might provide.

What type of capital flow are you seeing coming into Brazil right now?

We continue to see a traditional, north-to-south flow of capital, and in recent months, investments from foreign entities have begun to outpace local investments. More and more, we're seeing Brazil as a site for experimental funding. PE firms are taking an opportunistic approach and testing the waters, investing a marginal amount, such as 10 percent, instead of creating a dedicated Brazilian fund. Latin American funds are again growing in popularity, and Brazil is becoming a larger investment target within those funds.

We're also seeing more activity from family offices in the greater Latin American region. These wealthy families, who in the past have invested more informally and conservatively, are shifting their investing style to follow a more formalized model and strategic approach. These family groups have significant resources, and are moving to purchase companies in a manner similar to that of a private equity firm. A particularly notable trend has been increased interest from family offices based in Eastern Europe—having seen success among their own emerging markets, they are setting their sights abroad to replicate their gains in Latin America.

What trends are you seeing in terms of exits?

In short: No one wants to exit their investments right now unless they have a specific reason to do so. We're currently in a buyer's market, the credit rating downgrade is cutting return on investment. For the most part, we're mostly seeing activity among strategics, with many closing their doors and liquidating assets. We've also seen several large banks shutter their operations in Brazil as the recession continues.

Anything else to note?

Conservative investors are watching the market and investing in countries like Mexico, Peru and Colombia until they see how the economy fares. Argentina has also returned to the spotlight, given its recent change in government and the passing of market-friendly economic policies. The more aggressive investors are bullish and willing to put money down in Brazil right now to multiply it later on when the growth resumes. They're counting on the growing population, shifting income and renewed demand for goods as a sign of positive things to come.

For more information about private equity in Latin America please see the Fall 2014 issue of our BDO PErspective newsletter here or our BDO Spotlight with Bernardo Soto of BDO Mexico here.

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