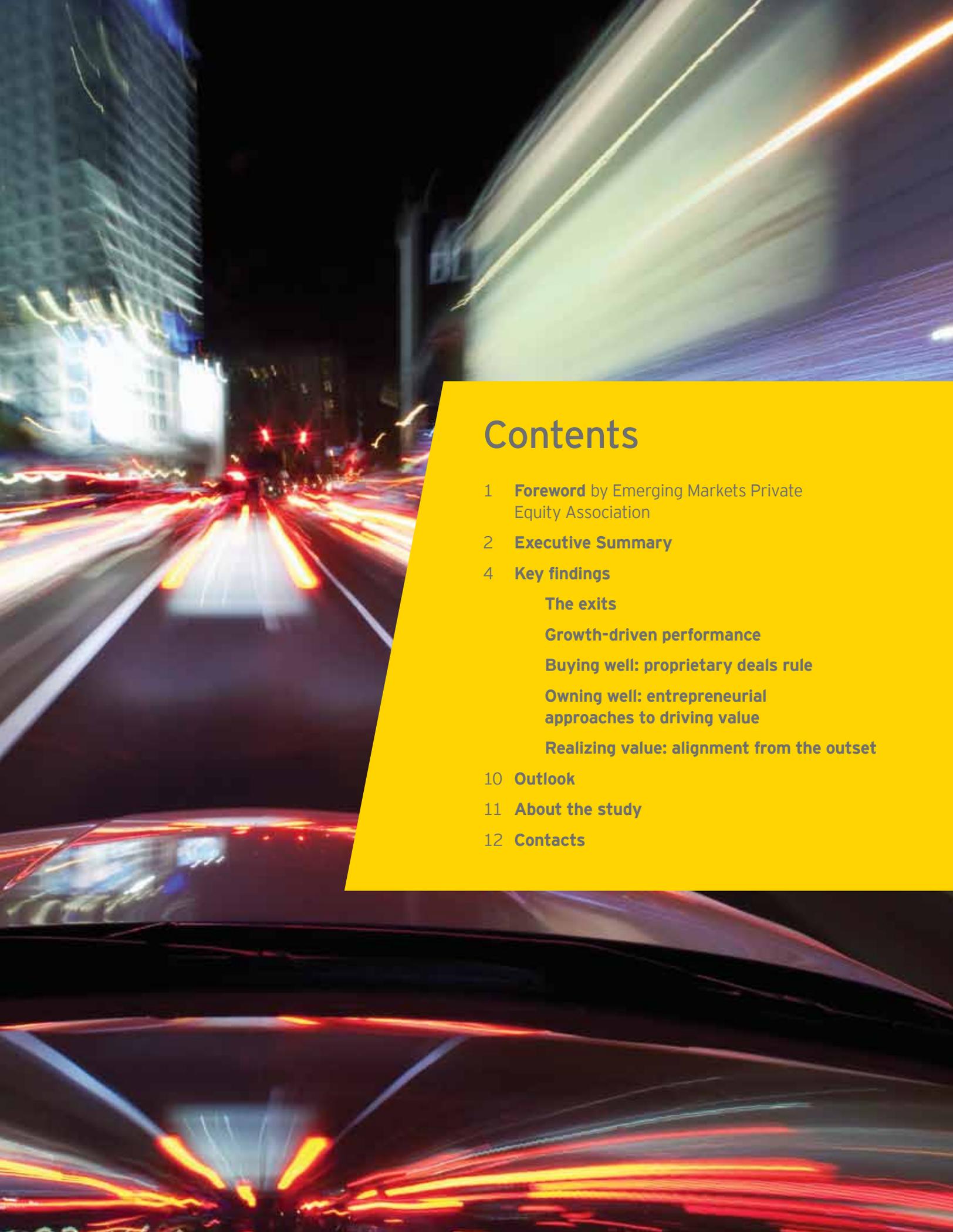




Dynamic growth: value creation in Latin America

A joint study of private equity exits in Latin America by EMPEA and Ernst & Young



Contents

- 1 **Foreword** by Emerging Markets Private Equity Association
- 2 **Executive Summary**
- 4 **Key findings**
 - The exits**
 - Growth-driven performance**
 - Buying well: proprietary deals rule**
 - Owning well: entrepreneurial approaches to driving value**
 - Realizing value: alignment from the outset**
- 10 **Outlook**
- 11 **About the study**
- 12 **Contacts**

Foreword



We are delighted to present the findings of our joint study on value creation with Ernst & Young, an analysis of exits in the Latin American markets.

EMPEA sees this research partnership with Ernst & Young as a critical step in addressing the industry's need for a fact base on private equity's ability to generate value for companies and strong returns for investors.

This information not only is critical to the investment decisions of institutional investors, but also informs policymaking in both the developed and the emerging markets. Like EMPEA, Ernst & Young understands the importance of the emerging markets to the future growth of private equity globally, and we are grateful for their support of our efforts to help develop this asset class by providing fact-based analysis of the opportunities and constraints facing global private equity investors.

Latin America – Brazil in particular – presents a compelling starting point for this research. As the outlook for the Latin American markets has improved, capital has followed. The region drew US\$8.4 billion in new commitments, or 22% of total private equity capital raised for emerging markets in 2011. This contrasts with only US\$700 million raised in 2004. In 2011, Brazil alone captured US\$7 billion in new capital commitments, or 23% of the US\$29.8 billion total raised for Latin America funds between 2004 and 2011.

More than ever before, institutional investors are seeking exposure to Latin America's attractive growth story, including rising domestic consumption and commodity wealth, coupled with impressive macroeconomic stability and fiscal discipline. EMPEA's 2012 Global Limited Partner (LP) Survey revealed that 65% of investors expect to initiate or expand their private equity investment programs in the region. As some Latin American LPs begin their private equity programs for the first time, and other domestic and international LPs take a second look, perhaps after disappointing past experiences, improving the quality of information on exits and value creation is particularly crucial.

Approaches to creating value in the emerging markets will no doubt evolve to changing local and global market conditions. With this study and others to follow, we aim to not only validate the returns thesis but also highlight replicable strategies for creating value and generating returns that reflect this evolution in best practice.

Finally, we are tremendously grateful to EMPEA's members for their support and participation, without which this initiative would not be possible. We look forward to continuing this important work with you and welcome your suggestions for portfolio companies to include in future analysis.

Sincerely,

A handwritten signature in black ink that reads "Sarah E. Alexander". The signature is fluid and cursive, written over a light gray rectangular background.

Sarah Alexander
President and CEO
Emerging Markets Private Equity Association



Executive Summary

Partnering for growth

Private equity (PE) investors have come out of the recession with a renewed focus on organic revenue growth, applying a more entrepreneurial mindset to working with their portfolio companies.

Spanning six years of analysis of companies exited in Europe and North America, Ernst & Young's studies of how PE investors create value confirm this shifting orientation toward growth and partnership with management teams. To uncover how value creation is achieved in the emerging markets, Ernst & Young and EMPEA teamed to produce this emerging markets edition of Ernst & Young's annual "How do private equity investors create value?" study, looking specifically at Brazil and Latin America. The study revealed that private equity in the rest of the world is once again closely resembling the model in the emerging markets.

In the Latin American exits we studied, PE firms are focused on growth and hands-on partnerships with entrepreneurs to transform companies into market leaders, and this approach is yielding strong results.

Although styles and strategies varied, what nearly all the exits had in common was that organic revenue growth was the primary driver of EBITDA (earnings before interest, tax, depreciation and amortization) growth and returns. In every deal analyzed, taking advantage of Latin America's impressive macroeconomic growth was a key feature of the investment thesis.

Buying well in such an environment is key – leveraging local teams and proprietary channels to find future market leaders in fast-growing but often highly fragmented industries. Nearly three-quarters of the deals we analyzed were sourced from private sellers, and two-thirds came either through the network or via active tracking of the sector. Just 20% were acquired through auctions. In finding the next market leader, PE buyers seek companies that can take advantage of demographic trends, such as rising consumer spending, or address bottlenecks to growth, such as infrastructure.

"We are finding that the rest of the world is evolving to replicate the model in the emerging markets – focusing on minority deals, equity deals, and working closely with portfolio companies to add value."

Philip Bass, Global Private Equity Markets Leader,
Ernst & Young

Entrepreneurial approaches are another defining characteristic of value creation approaches in Latin America deals. In many cases, the investment thesis hinges just as much on the potential for close alignment with incumbent management and the opportunity to transform the business model. In contrast to the North American and European markets, PE buyers in Latin America place more emphasis on improving the core business and preparing and strengthening management to ready companies for exit than on optimizing the capital structure and cashflow.

Enhanced financial discipline and corporate governance is the baseline in every deal, achieved through the installation of CFOs, controls and board-level engagement. Even where the PE buyer is a minority investor (as in the majority of deals), these are the key areas through which influence is vital, achieved through incentives and rights negotiated in the term sheet.



This approach to partnering with management to drive growth and professionalize the business nearly always includes a value creation roadmap, always of at least 100 days, and often longer. Implementation of these plans draws on the network of the general partner (GP) to tap new or cheaper sources of finance and strategic advisors to set direction and implement strategies. PE buyers make use of their own teams to complement the bench strength of their investees. This may take the form of a senior PE partner or deal team member acting as interim CEO, or even as CFO for the life of the investment. In other cases, senior PE partners engage solely at the board level, but do so intensely.

Strong alignment with management from the outset befits the current exit modalities in the region. Most exits are sales through private channels, often a buyer identified on entry or attracted by enhancements made through the PE partnership. IPOs typically play a very specific role in the investee's growth trajectory and are often identified at the outset as the preferred mode of exit to give time to prepare.

Continued growth of private equity in Latin America will naturally stress this growth-focused, hands-on model and create some opportunities for innovation and evolution. Robust economic growth and the overall good health of their portfolios have enabled PE firms to be highly effective with lean, generalist teams. There are few examples of firms with dedicated portfolio staff or operating partner networks, practices that are growing among US and European PE firms as they find new ways to add value to their portfolio. As flows of new capital to the Latin American markets put more pressure on valuations even as growth rates begin to slow, it will be critical for PE buyers to shore up their advantages and in some cases reposition to other market segments as a defensive measure.

Finally, our sample points to a gap in the Latin American market today, with secondary sales to PE buyers comprising only 5% of exits. With investor interest in Latin America showing no signs of slowing, there is a need to build toward a more cohesive ecosystem in which the middle market and the buyout segment not only coexist but together enhance the overall scale and quality of the investable universe. PE has yet a larger role to play in supporting economic and entrepreneurial growth in Latin America.

“Greater cohesion within the ecosystem – one in which the mid- and large-cap market segments work together to develop a viable secondary PE market – will be crucial to the flow of high-quality investment opportunities as these markets grow.”

Jennifer Choi, Vice President of Industry and External Affairs, EMPEA



Key findings

The exits

Our study looked at PE exits in Latin America between 2007 and 2011. The prevalence of privately sourced deals subsequently exited via private channels results in less transparency around Latin American exits, thus constraining the development of a definitive population. Drawing from initial research into 60 transactions executed across the region, we conducted interviews on more than 25 exits.

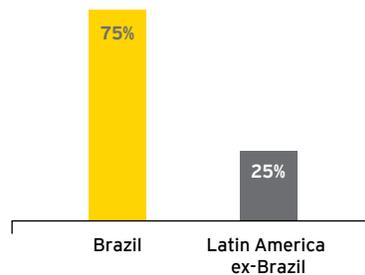
Mean IRRs in our sample compare favorably with the exits in our North American and European studies. Although the consistency of positive deal outcomes suggests some selection bias, this high-performing sample lends itself to an instructive analysis of successful approaches to value creation in the Latin American markets.

Consistent with the composition of the underlying investment population in Latin America, the majority of deals analyzed are minority transactions, comprising 55% of our sample. Of those, 70% are deals with stakes ranging from 20% to 50%.

EMPEA's Latin America data indicates that the majority of transactions are minority deals with median equity values of US\$14 million in Latin America markets outside Brazil and US\$45 million in Brazil. The transactions sampled for this study had an average entry enterprise value of US\$122.5 million, conveying average equity stakes of 48% or less.

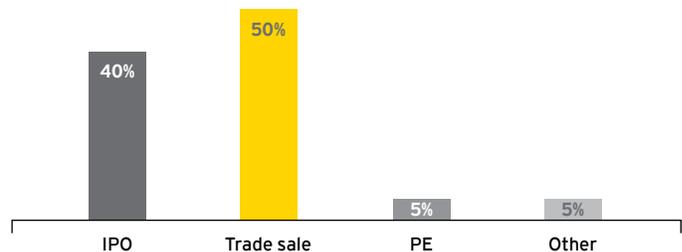
The sample was sectorally diverse, with consumer services and technology each accounting for 25% of the deals in our sample, followed by financials, industrials, health care and utilities. On a geographic basis, the sample was weighted toward Brazil, which accounted for 75% of the deals studied.

Fig 1: Exits by region



Source: Ernst & Young and EMPEA Latin America exits study, 2012.

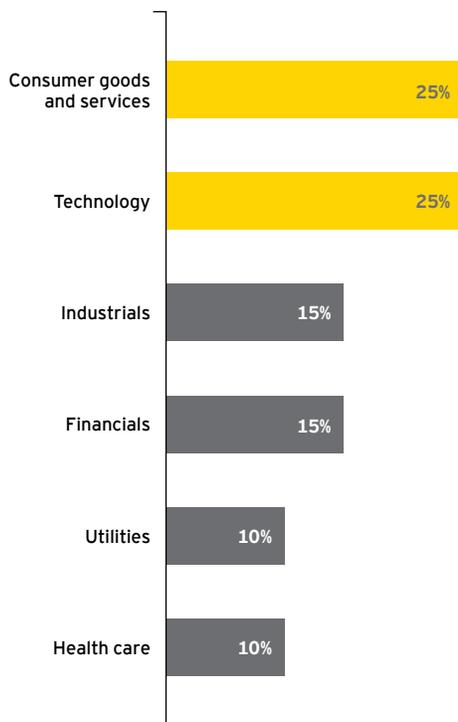
Fig 2: Exits by type



Source: Ernst & Young and EMPEA Latin America exits study, 2012.



Fig 3: Exits by sector



Source: Ernst & Young and EMPEA Latin America exits study, 2012.

Growth-driven performance

A resilient economy yields strong relative performance

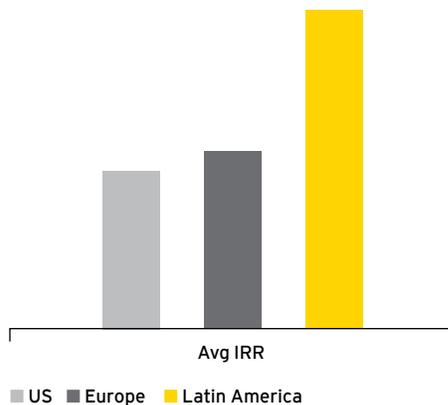
One of the key factors behind Latin America's success in recent years has been its resiliency in the face of adversity. In Brazil in particular, the country's ongoing shift from an export-driven to a consumer-based economy, combined with prudent fiscal policies,

helped insulate the nation from the worst of global economic volatility. Through the downturn, the region generally saw a significantly shallower recession and faster recovery than many of the developed markets.

As a result, average gross IRRs of the exits we sampled in Latin America compare favorably with returns from the best years of our studies in the developed markets, when we saw mean IRRs in excess of 50%. Overall, when compared with deals exited over the same period, returns in our Latin America sample exhibited IRRs that were roughly twice those of the US and Europe. Given underlying EBITDA growth rates of over 45% in the Latin America deals we sampled, compared with 13.5% in the US and Europe, this strong relative performance is not hugely surprising.

It is important to note that our sample size in Latin America remains small, and the consistency of positive returns suggests that there is some measure of selection bias. As such, our analysis is prefaced on the assumption that the approaches to creating value employed in these deals is somehow correlated with successful outcomes, even in the absence of a counterfactual or control set.

Fig 4: IRR comparison – Latin America versus US and Europe



Source: Ernst & Young and EMPEA Latin America exits study, 2012.



Key findings continued

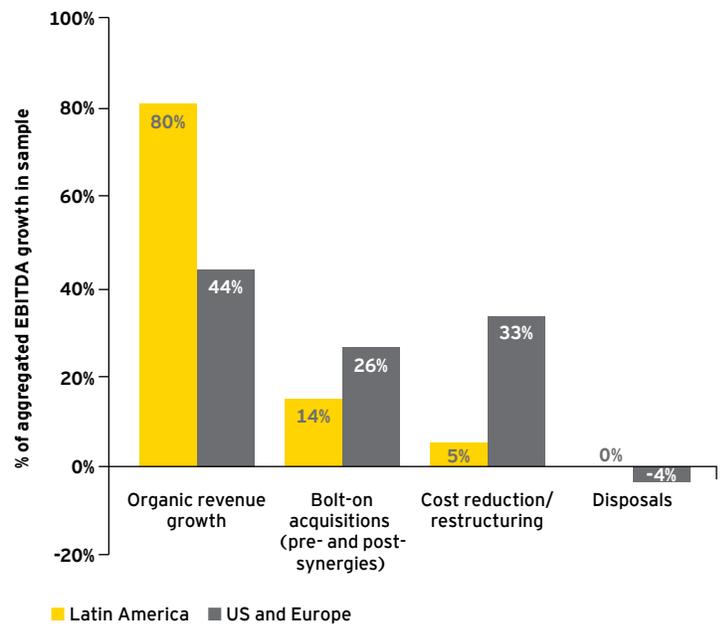
Organic revenue growth the overwhelming driver of returns in Latin America

The bulk of equity returns are driven by EBITDA growth, with leverage playing little to no role in the majority of transactions. Organic revenue growth fuels 80% of EBITDA growth in Latin America deals. This compares with organic growth's 44% contribution to revenue growth in the US and European studies.

80%

Percentage of EBITDA growth in Latin American deals that is fueled by organic revenue growth

Fig 5: EBITDA growth drivers – Latin America and US/Europe



Source: Ernst & Young and EMPEA Latin America exits study, 2012.

Despite the market fragmentation in these markets, particularly Brazil, add-on acquisitions are a comparatively minor factor, accounting for only 14% of revenue growth. However, while growing the core business is the focus of most investment strategies, add-on acquisitions are used to complement organic growth initiatives and vice versa.

Cost reduction, a significant source of profit growth in the US and Europe, has contributed far less in Latin American exits. This may reflect the nascence of companies and industries. This could also reflect the prevalence of “growth” versus “turnaround” investment rationales in our study sample, as well as less stress on portfolios as a result of robust macroeconomic growth in the region over the last few years.



Buying well: proprietary deals rule

More than in developed markets, network relationships – often informal – are key at every stage in the process, from finding good prospects to direction setting to final sale.

Auctions figured into only 20% of the deals we sampled, with proprietary deal flow featuring heavily – 65%. In cases where the initial purchase is through auction, a PE buyer’s demonstrated knowledge of the sector and overall reputation or chemistry with the seller is often the key to winning the deal, and can trump the highest bid.

65%

Percentage of the deals that were
proprietary sourced

Owning well: entrepreneurial approaches to driving value

While buying well is important in the Latin American market, an entrepreneurial approach to ownership is crucial, far more so than in developed markets. In the majority of deals sampled, the investment thesis hinged on backing entrepreneurs and professionalizing incumbent teams, the goal being to enhance or transform the core business model rather than completely “clean house.” This is important as later stage C-level overhauls more common in developed market deals can lengthen hold periods and drag down IRRs.

In three-quarters of the deals analyzed, PE firms backed founders or family owners, most commonly to execute on plans already in place (40%), and these deals averaged the highest IRRs. Partnering to jointly determine an improved course of action was a feature in 35% of the deals. Only one-quarter of the deals entailed bringing in new management and a new plan, including a handful of instances where the PE firm started a company to avail itself of an opportunity in the market.

Although the majority of deals in Latin America are non-control, PE buyers are minority investors with strong influence in decision making, achieved via strong partnerships with management, incentives and board-level advisory roles more so than through term sheets. However, in nearly every case, the ability to introduce financial discipline by deciding the finance function was critical to the deal. In 90% of deals studied, PE buyers installed a new CFO; the CEO (often a founder) was retained over 60% of the time; the CEO was replaced most commonly in majority-stake deals. Senior management teams were incentivized with equity or equity and bonus in 93% of companies in the study.



Key findings continued

Latin American PE buyers lend their resources to complement those of their portfolio companies, placing their own personnel as necessary, in many cases as interim CFO. Analysts are seconded on a part-time or full-time interim basis to assist in implementation of the 100-day plan or specific strategic initiatives. In a few cases, the team member sourcing the deal in turn becomes an employee of the investee company, remaining on the PE buyer's payroll. One GP noted that the senior partner in the firm sits on the board of every company in which the firm invests.

The question is whether this hands-on approach is sustainable in the face of market forces or macroeconomic instability that could put stress on a PE owner's entire portfolio. In Ernst & Young's other studies, some developed-market PE investors stung by the recession have created portfolio management teams to focus on optimizing financial controls, reporting and IT systems. With the premium placed on quality managerial talent in the Latin American markets, creating such dedicated portfolio teams will be more challenging but no less necessary.

In addition, the informal nature of most networks in the region is not necessarily optimal for sourcing the CEOs and CFOs critical to the success of each deal. Formalization of networks, such as the introduction of retained operating partners with sector and management expertise, could optimize the process of professionalizing management while freeing up precious senior talent from the PE team.

90%

Percentage of deals in which PE buyers installed a new CFO

Realizing value: alignment from the outset

In the majority of deals, the path to exit is identified at the outset, often because PE buyers are backing entrepreneurs or management teams with a vision for, and a vested interest in, the company's growth. PE buyers typically formalize these arrangements in the term sheet. However, PE investors were quick to note that alignment with the management team was important and critical to a successful exit. In three-quarters of the deals we analyzed, PE firms exited by the path they identified at the outset of the investment, whether by trade sale or IPO.

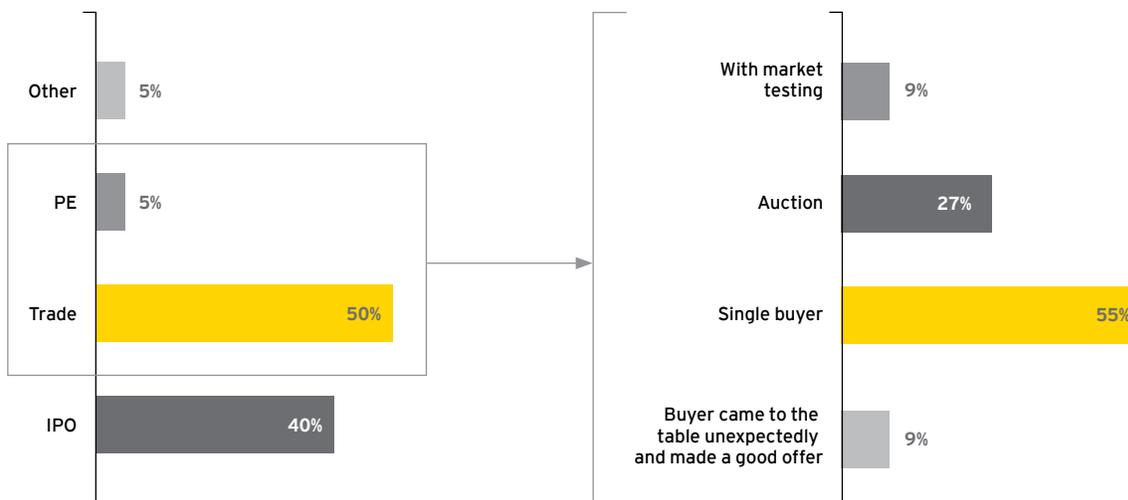
IPOs, comprising 40% of our sample and one-quarter of exits in the broader population, are frequently the realization of the envisioned trajectory for the deal but timed to market conditions. In multiple instances among the Brazilian deals studied, listings were in fact initiated, then suspended as the IPO window closed, and then later completed when it reopened. Interestingly, to a greater extent than in the developed markets, Latin American PE buyers tap public markets to finance additional growth prior to a full realization of the investment. On average, IRRs among deals exited via IPO were 10% lower than were exits by trade sale, though this could change as additional shares are sold via the public markets.

Whereas 74% of deals were sourced through private channels, half were sold through private channels, and for 40% the exit was an IPO. Of those exits via sales to strategic and PE buyers, nearly 75% were to a single buyer sourced through the PE investor's network or with some market testing. In many cases the PE buyer had actually identified a potential buyer at the outset of the deal. Auctions accounted for roughly one-quarter of exits.

Regardless of whether the mode of exit is to a strategic buyer or via the listed markets, PE buyers are executing on similar goals: introducing or improving financial discipline and corporate governance to ready the company for sale, which may mean elevating a company to the international standards required by multinationals or by retail investors in international markets.



Fig 6: Sales processes for PE and trade exits



Source: Ernst & Young and EMPEA Latin America exits study, 2012.

“Latin America continues to be a ripe region for investment with 65% of LPs expecting to expand or begin investment there.”

Jennifer Choi, Vice President of Industry and External Affairs, EMPEA



Outlook

Investor appetite for private equity in emerging markets and for Latin America in particular is at an all-time high. Emerging markets captured 15% of global private equity fundraising in 2011, up from only 4% in 2004. Latin American funds raised US\$29 billion between 2004 and 2011, with US\$8 billion raised in the last year alone.

EMPEA's research on LP sentiment indicates that there is no imminent slowdown in capital flowing to the region, with 65% of LPs expecting to expand or begin investment there, in search of superior returns driven by strong growth. Latin American markets beyond Brazil were ranked the most attractive markets for private equity deal-making in the coming 12 months, just ahead of the Brazilian market.

Given this building interest, the private equity model in Latin America may need to evolve over the near to medium term. As the pressure mounts to deploy capital or to gain exposure, the dynamics within the Brazilian market in particular could pose challenges for deal sourcing and pricing over time. The Brazilian government is also contemplating reforms that would encourage more early stage investment; more than US\$10 billion in recently-raised capital is poised to enter the Brazilian market in the medium term and global firms continue to come.

The question is whether these developments will lead to a cohesive multi-stage ecosystem, similar to that of the United States and Europe, where growth-focused middle market firms can do secondary sales to the buyout segment, or whether there will be greater concentration and competition within the middle market, where the vast majority of current opportunities lie. PE buyers focused on the middle market (i.e., growing US\$50 million companies into US\$200 million market leaders) must also consider ways to position their companies to take advantage of regional expansion, increasingly key as investors are looking for exposure to less-penetrated markets within Latin America.

Finally, as GDP growth slows and the modest scale of most companies becomes a hurdle to returns, the focus of the current PE operating model in Latin America will need to broaden beyond growth. This could include an increased focus on turnaround opportunities – like those invested in by North American and European PE investors.

As organic growth becomes harder to come by, PE buyers will need the full complement of value creation strategies, including skills in executing bolt-on acquisitions and restructurings, to manage through a more competitive environment and the global macro headwinds that could yet come to Latin America.

Despite this uncertainty, there is good news. In a recent survey of young entrepreneurs in Brazil conducted by Ernst & Young, 72% stated that financing for their business ventures was a challenge. And 98% thought PE could help fill that gap, with a medium to high impact to improve long-term growth of entrepreneurs. An entrepreneurial focus on growth has been crucial to PE's success so far in the Latin American markets. It will be ever more pivotal as the industry continues to grow, and as PE plays a broader role in the rapid economic growth in Latin America.

“PE buyers will need the full complement of value creation strategies and entrepreneurial focus to continue the industry's growth in this region.”

Philip Bass, Global Private Equity Markets Leader,
Ernst & Young



About the study

The 2012 Latin America study examined the results and methods of PE exits between 2007 and 2011, using similar methodology to the US and European studies. Data was drawn from various sources, including EMPEA, and confidential, detailed interviews with former PE owners of the exited businesses. Initial research was performed into 60 transactions across the region, with interviews conducted on more than 25 exits.

Our analysis entailed an examination of the decision to invest, value creation during ownership, the exit strategy and key lessons learned. The consistently strong returns in our sample indicate some selection bias in the data. However, as the analysis draws on practices associated with generally successful deals, we believe that it is valid to assume some correlation between those strategies and the strong returns presented here.

Given the limitations of the data, our aim in this inaugural study was to produce an important but not necessarily statistically significant sample of deals, analysis of which would enhance the understanding of exit modalities and strategies in these markets and the underlying drivers of value creation.

The size of the sample is a function of the availability of data on exits in these markets – our primary motivation for embarking on this research – and the extent of participation from the PE community. We are tremendously grateful for the generosity of those participating in this study and appreciate both their time and input.

We look forward to continuing to bring you insights into private equity value creation in both developed and emerging economies in the coming months and years.

About EMPEA

The Emerging Markets Private Equity Association (EMPEA) is an independent, global membership association whose mission is to catalyze private equity and venture capital investment in emerging markets. EMPEA's 300 members share the belief that private equity can provide superior returns to investors, while creating significant value for companies, economies and communities in emerging markets. Our members include the leading institutional investors and private equity and venture capital fund managers across developing and developed markets. EMPEA leverages an unparalleled global industry network to deliver authoritative intelligence, promote best practices, and provide unique networking opportunities, giving our members a competitive edge for raising funds, making good investments and managing exits to achieve superior returns.

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