

Building vital partnerships

How do private equity investors create value?

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

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Foreword



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

EMPEA's partnership with Ernst & Young has yielded important insights into the role of private equity (PE)

investors in delivering value to both investors and investee companies. We commend Ernst & Young for lending methodological rigor to producing this analysis globally. Hard facts such as those shared in this report are pivotal to the investment decisions of institutional investors and to better informed policymaking in developed and developing countries alike.

This second study on PE exits in Latin America delves deeper into the region beyond Brazil and provides further evidence of how PE firms help entrepreneurial companies professionalize and grow. While Latin America's importance as an investment destination continues to grow, capturing 21% of emerging markets PE investment in 2012, there remains a sizable financing gap in these markets. PE accounts for less than 0.1% of GDP in Latin America, and a large majority of fast-growing companies remain undercapitalized.

The good news is that investor interest in the region is still climbing. According to EMPEA's Global Limited Partner Survey, 46% of institutional investors surveyed in 2013 plan to commit more capital to Latin America beyond Brazil. As many investors look to the region anew or enter for the first time, and as entrepreneurs seek out partners that can offer more than just capital, it is more crucial than ever to expand the body of evidence demonstrating the value that PE delivers in Latin America.

We thank our members for their invaluable contributions to this year's study, and we are grateful to Ernst & Young for its commitment to supporting the future growth of PE in emerging markets globally. We look forward to amplifying our partnership with Ernst & Young to produce fact-based analysis on exits in Latin America and in other emerging markets, and we encourage you to join with us in this research going forward.

Sincerely,

A handwritten signature in cursive script that reads "Jennifer Choi".

Jennifer Choi

Acting CEO

Emerging Markets Private Equity Association

Executive summary

Latin America



6th



In less than a decade, Brazil has surpassed the UK, Italy and Canada to become the sixth-largest economy in the world.

>4%



Latin America has continued to outpace developed countries in economic growth, with region-wide GDP growth averages hovering above 4%.

50%



The middle class has grown by 50% over the last 10 years, and now represents 30% of the population.

Our second annual study, looking at how PE investors create value in Latin American businesses, extends our research into PE's transformational role in Latin America's continued economic development. The results of this year's study confirm our initial findings – PE firms are focused on growth and hands-on partnerships with entrepreneurs to transform companies into market leaders. Through extensive involvement, PE investors work with the entrepreneurs they back to identify and develop new products, expand geographically and exit profitably.

Our study looks at PE exits in Latin America between 2007 and 2012, a period of economic stability and prosperity unrivaled in a generation. In less than a decade, Brazil has surpassed the UK, Italy and Canada to become the sixth-largest economy in the world. In addition to Brazil, neighboring countries such as Colombia, Peru and Mexico have also come into the spotlight as the current rising stars of the region. This year, we're seeing more PE interest in the region beyond Brazil.

Colombia and Peru have consolidated economic reforms to become hubs for foreign direct investment. And Mexico, long hindered by market concentration and low productivity in key sectors, is now pursuing serious structural reforms to bolster competition.

Latin America has continued to outpace developed countries in economic growth, with region-wide GDP growth averages hovering above 4%, despite a difficult commodity export market and continued challenges in generating competitive industries. To compensate for the drop in external demand, many economies in the region powered ahead, buoyed by the rapid growth of the region's middle class and the local consumption effects of nearly 50 million people who have risen out of poverty in the last decade. This has had profound implications on certain sectors in countries where these trends are most prevalent, particularly in Brazil, Colombia, Mexico and Peru.

The rise in prominence of these markets outside Brazil is reflected in the results of this year's study, with a sample that is more balanced and less biased to the most mature PE market in the region. And while PE-held companies still represent only a small percentage of GDP across the

“Institutional investors continue to seek exposure to Latin America’s attractive growth story fueled by the desire to build partnerships and foster the entrepreneurial spirit.”

Michael Rogers, Global Deputy Private Equity Leader,
Ernst & Young

region, particularly compared with developed economies, our study sample shows that PE firms have captured an important share of some of the most dynamic and fastest-growing sectors in Latin America’s rapidly changing markets. Comprising more than 50% of the exits in our population, retail and consumer goods, financial services and health care have been able to profit from the rapid rise in middle-class consumption following several years of stability and prosperity.

PE provides a level of strategic partnership and professional guidance that helps local entrepreneurs grow their businesses. While PE brings professionalization and financial discipline and strengthens corporate governance, just as importantly, it also brings operational expertise and its extended network to support their businesses.

As entrepreneurs in the region seek to conquer new markets at home and abroad, PE is giving them the crucial resources to help them achieve these goals. With growth capital dominating PE activity in the region and the focus on organic growth, PE fund managers are taking a meaningful and active role in helping entrepreneurs create value.

Also, as the market continues to mature, we are beginning to see a transition into a two-tier firm model. This reflects a market where large Brazilian and international buyout firms compete for deal flow at a very different level than traditional regional or domestic PE firms. This is a welcome response to a challenge we pointed out last year where the amount of capital coming into the region did not match up with deal activity. With large funds now coming in to open up scale and globalization, small and mid-market firms can continue their focus to build better businesses. If this continues to evolve in this direction, the Latin American regional PE model would more closely resemble the multistage PE ecosystem in many developed markets.

The domestic and foreign PE firms willing to commit to Latin America over the last several years have generated returns above those available in local public equity markets, even surpassing what PE firms in developed countries have seen. Exits in Latin America continue to perform favorably compared to those in developed countries, and the region is showing a historic level of dynamism in activity, depth and maturity. The slowdown in IPO activity has resulted in new routes to exit developing inside and outside Brazil, including a vibrant market for private and secondary sales. Our study delves deeper into these trends and the drivers behind the increasingly sophisticated landscape for exits, with an attempt to quantify some of the key practices that have delivered the greatest value.

As PE continues to develop and mature in Latin America, it will play an increasingly vital role – providing the necessary capital, discipline and expertise required to help the Latin American economy achieve its full potential.

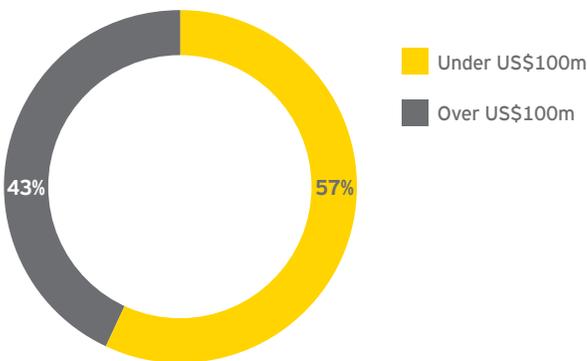
Key findings

The exits

Building on our initial value creation study on Latin America last year, this year's study examines PE exits in Latin America between 2007 and 2012, drawing from initial research of a population of more than 70 transactions executed across the region. The exits analyzed over the period are spread across a range of countries, sectors, strategies and sizes.

Nearly 60% of our sample is composed of deals with values less than US\$100m. Of those, 56% had entry enterprise values (EVs) of less than US\$25m; 28% were between US\$26m-US\$50m; and the balance fell between US\$51m-US\$100m. This is consistent with the overall market.

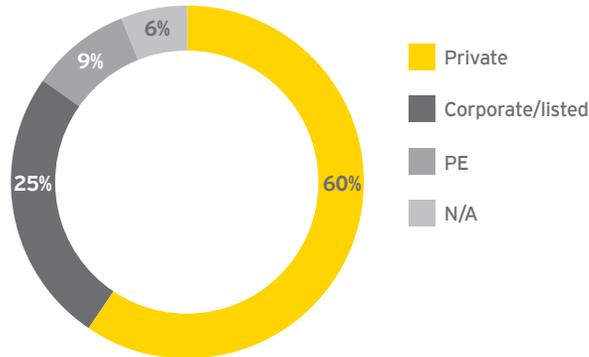
Figure 1. Exits by entry enterprise value



Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

Private sources of deal flow remain central to prospective PE buyers. In this year's sample, 60% of investments surveyed were initially sourced through private channels, while just 25% came through corporate or listed markets. Small and mid-market deals showed an even larger tendency toward private sourcing sales, with more than 70% sourced through private sellers versus 31% for deals above US\$100m.

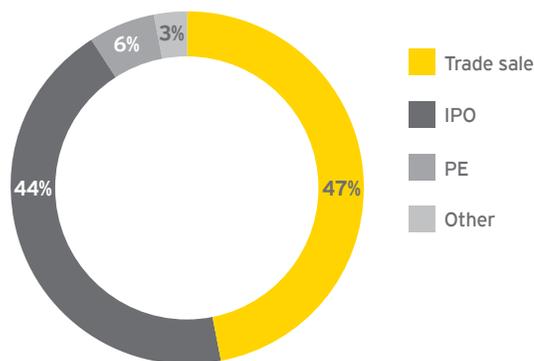
Figure 2. Exits by entry modality



Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

The preponderance of private routes to deals is similarly reflected in the route to exit. Fifty-three percent of investments in the sample were exited through trade or secondary sales, although a limited number of the deals that were sourced privately at the outset were exited via IPOs. And these private exits are happening in favorable conditions with eager buyers. Nearly 95% of all the exits we studied reported strong business performance or favorable market circumstances as principal triggers for exits.

Figure 3. Exits by type



Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

The recent uptick in interest by investors in the breadth of the Latin America opportunity is reflected in this year's sample. While Brazil still comprises the largest portion of the sample (56%), exits in Mexico represent 16% of our sample this year and Colombia 10%. Exits in Peru, Chile, Uruguay and Argentina make up the balance. This is more indicative of the growing activity by PE elsewhere in the region.

The key theme on which we reported last year remains true: PE firms continue to work with entrepreneurs to drive growth and implement new, higher standards of governance; instill financial discipline; enhance management; and help companies professionalize, expand and avail themselves of Latin America's growth curve. The benefits that PE can and does contribute are filling a highly needed gap in the Latin American market, particularly since small deals still make up a large portion of the market.

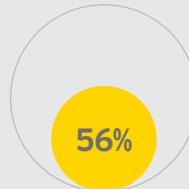
Beyond this, we also see two new themes emerging. The first theme is an ecosystem that continues to develop and mature – coupled with the concurrent emergence of a two-tier model. In the earlier and mid-stages, PE firms will continue to help companies in the middle market to professionalize while growing revenues and EBITDA. At the same time, larger PE firms, both local and global, are increasingly looking to execute on larger transactions with bigger transformation agendas. This bodes well for the development of a PE pipeline similar to that seen in developed markets, where different stages of investment involve different types of capital and strategy.

The second new theme is the growing role that geographic expansion plays for many companies in Latin America. In many cases, this expansion was simply beyond home territories into the rest of Latin America. With the larger deals, we found PE firms actively working with companies to expand internationally. This will be an important component of the maturation of the PE market across Latin America in the coming years.

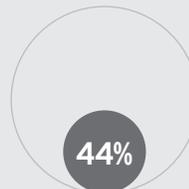
“The domestic and foreign PE firms investing in Latin America over the last several years have generated returns above those available in the region's public equity markets.”

Jennifer Choi, Acting CEO, EMPEA

Figure 4. Exits by region



Brazil deals



Latin America deals excluding Brazil:

- Mexico – 16%
- Colombia – 10%
- Chile – 6%
- Uruguay – 6%
- Argentina – 3%
- Peru – 3%

Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

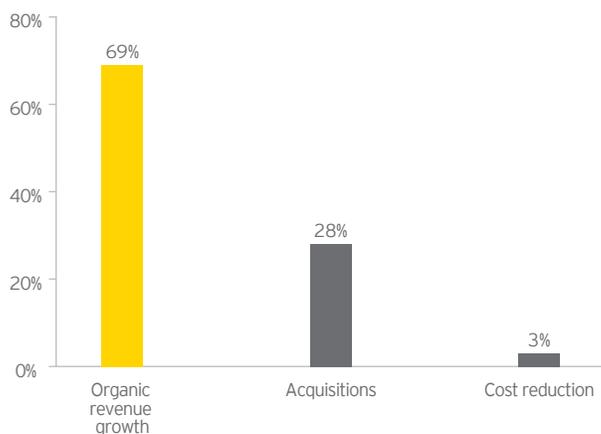
Key findings continued

Partnering with entrepreneurs to drive growth

PE investors are benefiting from sustained economic expansion in Latin America and a level of durable macro stability that has largely been unprecedented in most of the region.

In line with our report from last year, one of the most striking features of Latin American PE when compared with developed and other emerging markets is the near-universal focus on portfolio company growth. Across the entire sample, organic revenue growth accounted for 69% of earnings before interest, tax, depreciation and amortization (EBITDA) growth. Acquisitions accounted for over 28% of EBITDA growth. In sharp contrast to the developed markets, where cost reduction initiatives play an important role, cost reduction in Latin America accounted for less than 3% of total EBITDA growth.

Figure 5. EBITDA growth drivers

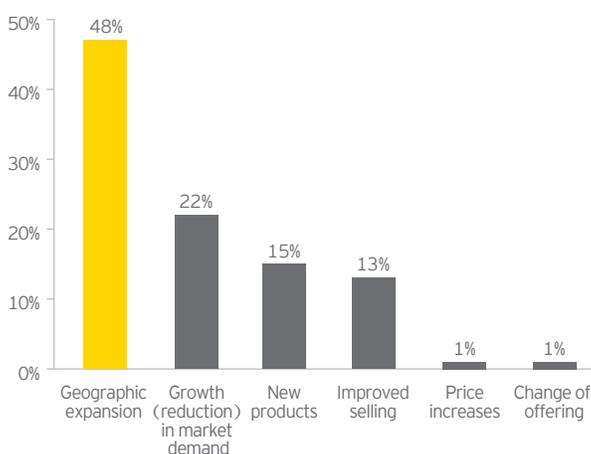


Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

Moreover, our more robust data set has allowed us to further deconstruct the drivers behind this growth. Notably, 48% of organic revenue growth was attributable to geographic expansion and 28% was driven by the introduction of new product lines and enhanced sales processes. For some companies this has meant working with sales forces to introduce performance-based programs to better align incentives. Others developed new marketing techniques in order to access previously untapped markets.

The balance of organic revenue growth came from overall growth in the market – 22% of organic growth was attributable to this. Astute sector selection is the key here – in the many cases we examined, PE firms were able to identify sub-sectors that would not only match Latin America’s rapid growth rate, but exceed it by a significant margin. Seventy-two percent of the companies with significant EBITDA growth from market demand were in the sub-sectors of the consumer goods or financial services industries.

Figure 6. Breakdown of organic revenue growth



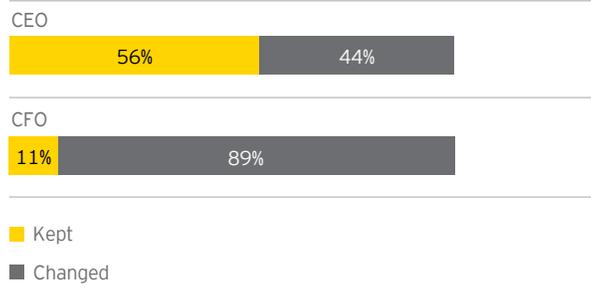
Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

Such deals traded on the growth of domestic demand. While consumer services or consumer goods companies comprised less than 30% of our sample, other industries directly related to middle-class consumption growth, like health care and financial services, increase the total to more than half of the exits we studied. Expanding product offerings and opening up new consumer markets has proven a lucrative and scalable strategy for PE-backed businesses active in the region. Given continued growth, we would expect to see additional interest from local and foreign firms alike, particularly in those sectors with strong alignment to consumer spending – durable goods, retail, health care, education, financial services and others.

Similarly, financial services has seen significant PE interest over the last several years, and many of those investments have been realized in recent quarters. Increased access to banking products and consumer credit has been a powerful trend in Latin America, and PE firms have been at the forefront. Deals in the financial services space made up 28% of our sample.

Whether through peer networks or through detailed sector experience, local market knowledge continues to be the primary source of deal flow. Many Latin American entrepreneurs seek out partners that they can trust with their businesses' brands and reputations, often favoring reputation and a high level of confidence in a potential purchaser over the highest bidder.

Figure 7. CEO and CFO changes



Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

PE buyers generally retain the company's CEO as they are often key to the company's strategy, success and public leadership – 56% of the exits studied in our analysis kept the CEO. Where PE does effect more change is within the CFO function, and our study reveals that almost 90% of buyers install a new CFO, with the majority of these changes coming during the early stages of investment. Both CEO and CFO replacement is more prevalent in larger deals, which supports the notion that larger Latin American deals need more experienced management to get them to the next level.

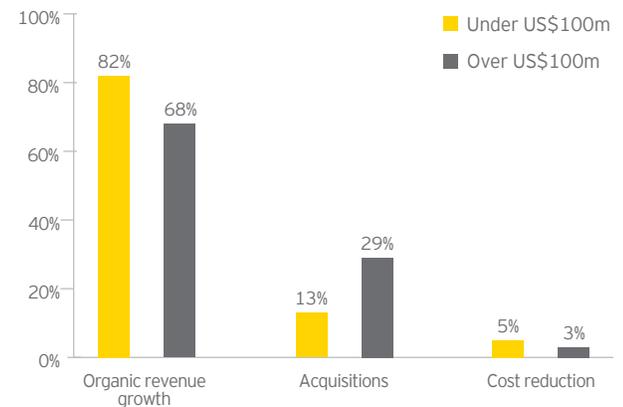
Recruiting and retaining top management talent is already a serious concern across much of the region, and as additional PE assets are deployed, the competition for the best and brightest could intensify. Many firms have already taken steps to formalize their networks of operating partners and invest in portfolio support teams, following the developed market model. As PE in the region continues to mature, this could be a key differentiator for investors.

Two models at work in Latin America

A deeper look into our research uncovers some significant differences in the ways that PE firms are driving growth. In addition to the growth capital investments common to emerging markets, our sample also included a number of larger deals with profiles more similar to European or US buyouts.

In those deals with an EV above US\$100m, organic growth made up more than two-thirds of overall EBITDA growth. This was still much higher than that of the developed markets, with the balance driven almost entirely by acquisitions (29%), often as a means of entering new markets, consolidating competitors or effecting geographic expansion. However, unlike many US and European buyouts, cost reduction as a factor in Latin America had a minimal effect, comprising just 3% of EBITDA growth, as compared with 28% in the US.

Figure 8. EBITDA attribution by entry enterprise value



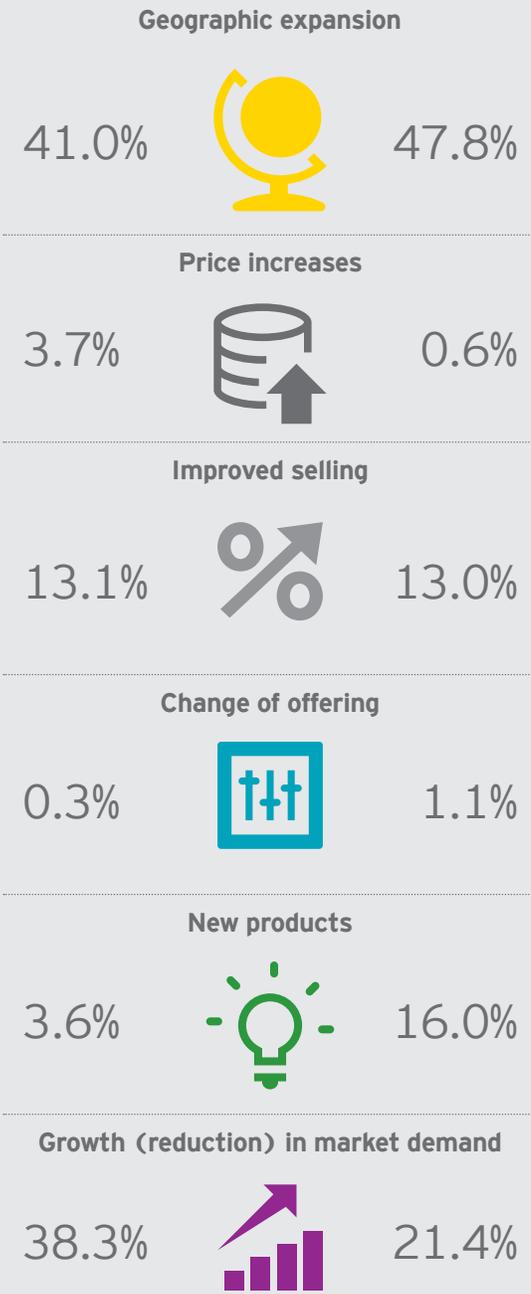
Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

In contrast, smaller and mid-market deals demonstrated markedly different characteristics. Companies in the sample with EVs less than US\$100m showed a similar but larger reliance on organic growth, with 82% of total EBITDA improvement coming from organic growth, 13% from acquisitions and just 5% from cost savings.

Key findings continued

Figure 9. Breakdown of organic revenue growth by entry enterprise value

Under US\$100m Driver Over US\$100m



Much of this organic growth came from adding incremental market share and customers in their immediate geography. Growth in market demand accounted for nearly 40% of small-company EBITDA growth, compared with 21% for larger deals. In this category of our sample, and particularly in businesses with EVs below US\$25m, 39% reported plans to expand into new cities and areas of their home countries. Additionally, sector selection was a key driver of returns in this segment, while geographic expansion was a common component of both large and small deals, it was 15% larger in the bigger deals.

These findings appear to be consistent with the development of a multistage model – where small and mid-market firms focused on prudent sector selection, operational expertise and work closely with entrepreneurs to opportunistically grow the business. At the same time, firms at the larger end of the spectrum are effecting change through an increased focus on geographic expansion, in many cases throughout Latin America and elsewhere, and moves into new markets with outsized potential.

According to a 2011 survey conducted by Ernst & Young, 72% of entrepreneurs underscored the difficulties in accessing funding. Moreover, 98% of those surveyed said that PE could have a medium to high impact in closing the funding gap. Small and mid-market funds are poised to play a critical role in addressing this need. However, what they bring to the table is far more than just capital – entrepreneurs are increasingly looking to PE for operational expertise, whether from dedicated portfolio operations teams, or from general partners (GPs) that have experience working with similar businesses. With solid foundations in place, these companies will be attractive targets for larger firms, which can take businesses to the next level – adding new product offerings or expanding regionally or internationally.

With business transformation becoming more of an imperative, firms are beginning to invest in portfolio support teams. This may prove to be a differentiator in the future.

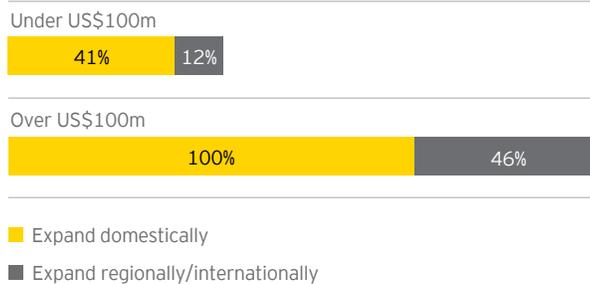
In an environment that has seen a tremendous amount of capital flow into the market in a short period of time, the development of a two-tier model will be critical to the continued growth and stability of the PE ecosystem in Latin America.

Internationalization

The final theme we identified in our 2012 study of PE exits was the growing trend toward geographic expansion as a means of growth. Domestic expansion was the key focus for companies with EVs above US\$100m with 100% of the sample reporting new domestic markets as part of a growth strategy.

Increasingly, however, international growth is becoming a focus as well. From our sample of businesses with EVs over US\$100m, nearly half are pursuing international expansion alongside domestic expansion. And while Brazil remains a target market for many companies based in smaller countries like Chile or Colombia, growing a Latin American business has gone beyond its former regional focus, and many have set their sights squarely on expansion in other emerging and developed markets.

Figure 10. Geographic expansion



Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

Our study also measured whether minority or majority strategies had a measurable impact on EBITDA growth. After observing a slight tendency toward minority stakes in 2011 – 55% – the additional data this year made for a roughly even split between majority stakes and minority stakes in the sample.

Many deals in our sample took the form of minority stake deals with PE managers actively involved in the execution of management plans. A number of other deals demonstrated the growth in co-investing strategies across the region, with two or more PE firms taking control of a company through combined minority stakes, spreading risk and broadening advisory capacity. We noted that many of the larger transactions in the sample were also minority stake investments, reflecting only an effective scale-up in the size of companies receiving PE backing.

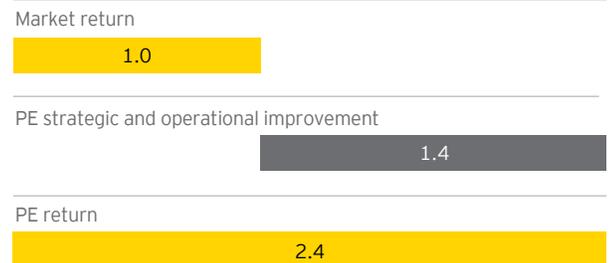
Attractive returns relative to developed markets

Growing companies organically has been a profitable strategy for Latin American PE firms. Mean internal rate of returns (IRRs) in the region continue to compare favorably with returns from the US and Europe. While there is likely to be some statistical bias to the reporting of successful deals versus more negative outcomes, we are comfortable that our sample accurately reflects the approaches PE firms take to creating value in their Latin American portfolio companies.

Moreover, PE returns in Latin America compare favorably relative to what investors have achieved in the public markets. Our analysis showed that PE deals returned 2.4 times the market return (as defined by the Ibovespa Index) over an identical period. With leverage a limited factor, these figures confirm the notion that PE investors add significant value above and beyond the overall market return – often through market expansion, the acquisition of new customers and taking full advantage of the favorable macroeconomic environment across the majority of countries in the region.

Given the structure of Latin America's stock markets, and the BM&FBovespa in particular, it also speaks to the ability of investors to achieve exposure to a much greater share of Latin America's growth story via PE investments. With a market capitalization of approximately US\$1.3t, it ranks among the world's largest exchanges. However, much of this is concentrated among a number of the region's largest companies and representative industries.

Figure 11. PE return relative to the market



Note: Market return is based on returns to the Ibovespa during the holding periods of exits in the study.

Source: *How do private equity investors create value?: 2013 Latin American Study*, Ernst & Young and EMPEA, 2013

Outlook

Our study into Latin American exits between 2007 and 2012 confirms one of our central themes from last year: Latin American companies, across various sizes and industries, have sought out PE to fill gaps that could not be addressed in local debt and equity markets. PE has played a crucial role in helping companies reach new customers, enter new markets and create value for consumers and investors alike. As Latin America's PE ecosystem continues to expand and mature, a multistage model continues to develop. A robust market exists, and will continue to exist, around building and growing stronger businesses – particularly helping those in the middle market to grow revenue and EBITDA.

While a favorable economic climate and improved management can drive local growth, PE firms are helping companies expand beyond their home markets to capture domestic and, increasingly, international scale. As economies across Latin America mature and develop, and as exporting goods and services becomes easier through better trade links and lower tariff barriers, PE portfolio companies are in the lead position to capitalize on these market shifts. PE is also bringing in operational expertise.

Regional integration is happening between countries that in the recent past had few trade linkages and inefficient state industries competing for international share of principally commodity markets. For instance, Andean markets have been natural export partners despite physical distances and geographic barriers and are now approaching a point where Chile, Peru and Colombia are integrating their stock markets to deepen local capital markets. Through market reforms and sustained growth, Brazil has surpassed the US and Asian countries as the most desirable export market for certain goods and services. This has happened organically while government-led attempts to integrate the Southern Cone (southernmost region of Latin America including Argentina, Chile, Paraguay and Uruguay) and the Andean region have stalled.

Unlike in the not-so-distant past, where the public sector was responsible for promoting state enterprises at home and abroad, the economic goal many governments in the region have now is to protect macroeconomic stability in order to facilitate the growth and dynamism of a private sector increasingly geared toward local

consumers. This is translating into successful local businesses becoming regional and global businesses. PE firms are ideal partners to facilitate this growth, and our sample shows that this is already happening in meaningful, quantifiable ways.

Through detailed industry knowledge, deep local connections and unparalleled market access, PE has created a unique opportunity for Latin American entrepreneurs. Even with regional and strategy variations, our study confirms the notion that PE is helping companies to expand their markets, acquire new customers and take advantage of the favorable macroeconomic environment across the region.

Beyond driving revenue growth, we are eager to keep watch on whether PE will implement new strategies to create value. Will PE increase its pace of bolt-on acquisitions to drive growth in portfolio companies? Changes across some sectors, with competition being introduced for the first time, are playing a role in this trend. This is broadly causing industry fragmentation, and the roll-up opportunities these present are an important theme we have seen across these sectors.

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 cost reduction as a lever to drive value creation.

We also expect to see new strategies reflective of a maturing market. In the small-cap and middle markets, deep local knowledge and networks will drive deal flow and value creation, as PE firms work with entrepreneurs and family owners to instill discipline and professionalization. At the larger end of the market, we are already seeing larger-scale investments from local and foreign PE firms.

PE buyers will need a full complement of value creation strategies as organic growth becomes harder to achieve. This includes skills in executing and integrating, bolt-on acquisitions and broader business transformation.

The PE industry has proven to have a positive impact on the increasingly important region of Latin America; it now has to expand its strategies and reach as it manages through a more competitive environment and the expected volatility in Latin America.

About the study

Now in its second year, the Latin America study examined the results and methods of PE exits between 2007 and 2012. Drawing upon confidential interviews with PE firms active in Latin America, and public documents and data sources, the study drew a sample from an initial population of over 70 exits.

The sample used in our analysis does not aim to be exhaustive of all exits in the region over the past several years. Rather, it is a representative sample of deals sourced from EMPEA's data on Latin American exits combined with confidential, detailed interviews with former PE owners of the exited businesses. Given the prevalence of private deals and exits in Latin America, there is an inherent constraint in reporting on an exhaustive sample. For this reason, we chose a sample where we can source reliable information that reflects the large amount of non-public activity across the region.

We look forward to continuing to deliver key insights into value creation modalities in both the emerging and developed markets. In addition to the Latin America study, Ernst & Young and the African Venture Capital Association (AVCA), with support from EMPEA, recently collaborated on a similar study on African exits. Additionally, Ernst & Young has conducted studies in the US and Europe for six and seven years, respectively.

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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