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BRAZILIAN PRIVATE EQUITY OUTLOOK

Andrea Maria Accioly Fonseca Minardi (Insper)
Humberto Gallucci Netto (Spectra)

HIGHLIGHTS

We observe a shrinkage of Private Equity (PE) firms focused on the traditional PE model in Brazil. The number of active PE firms declined from 54 to 29 between 2012-2022. Among the twenty-nine firms that are active[1] in 2022, we have three that are in their first fund's investment period, seven do not have a blind pool fund, but are instead executing deal-by-deal investments and the remaining nineteen are in their second or higher order fund's investment period.

Nevertheless, all of these active firms have partners with extensive PE expertise in their teams: general partners (GPs) that are executing deal-by-deal investments have an average of nine years of experience in Private Equity; first-time fund firms are run by partners who have an average of 14 years of PE experience, and GPs that raised more than one fund have an average of 17 years of experience in private equity.

Dry powder in Brazil has reached the lowest level in the last ten years: BRL 17 billion (USD 3.3 billion) in 2022 compared to BRL 27 billion (USD 7.7 billion) in 2016. The drop in dry powder is explained by the decrease in investments by both foreign investors and domestic pension funds and by the popularization of other illiquid investment thesis in Brazil, such as venture capital and legal claims, which compete for the same pockets.

Fund raising activity is linked to past performance. Previous funds of active houses on average outperformed industry vintage in all metrics: IRR and TVPI, both in BRL and USD. Meanwhile, previous funds of the firms that have closed or are inactive [2]on average underperformed industry vintage.

PE managers generate value for invested companies, even in years of economic crises. The average rate of annual revenue growth of all PE backed companies has never been below 10%, and. in years of high economic growth, it approached 30%. Similarly, the average EBITDA annual growth rate has also never dipped below 8%, and in some year of economic boost, it exceeded 30%.

The share of Private Equity firms' portfolio composed by Tech companies has been increasing. In 2020, it corresponded to 15% of the PE deals. There are three contributing factors for this: companies invested by venture capital firms grew to late stage, and became targets for PE; the growth of Tech companies is uncorrelated with economic growth, and serves as potential hedge for BRL devaluation, and lastly, Tech companies have multiple outputs above traditional companies.

It is reasonable to expect good and consistent returns for the next vintages. Entry multiples are low due to a combination of low competition for PE deals and market correction, and active managers have teams with PE expertise who generate value for invested companies.

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[1] We defined active PE manager the firms that had either dry powder or are raising capital deal by deal.

[2] During the period of 2012 and 2022, eighteen firms were closed of which seven were foreign houses and two had been founded after 2012 and closed before 2022. Furthermore, there are sixteen firms which are still managing their present portfolios, but have run out of dry powder and not raised any new funds, and therefore, were classified in this study as inactive firms. Among these sixteen inactive firms, six are monitoring their first fund, and ten are running their second or higher order fund.

TWO DECADES OF CHANGES IN BRAZILIAN PRIVATE EQUITY SECTOR

The number of active Private Equity firms in Brazil increased consistently between 2001 and 2012: from 27 to 54 managers. This growth is mainly explained by the increase in the number of domestic Private Equity firms, which grew from 14 to 39 in the same period, while the number of foreign managers investing in Brazil remained stable (Figure 1). The notable growth of fund managers is certainly related to the country's average GDP growth of 3,6% p.a. in the period, motivated by the boom in commodities, increased consumption, credit expansion and the rise of the purchasing power of the middle class.

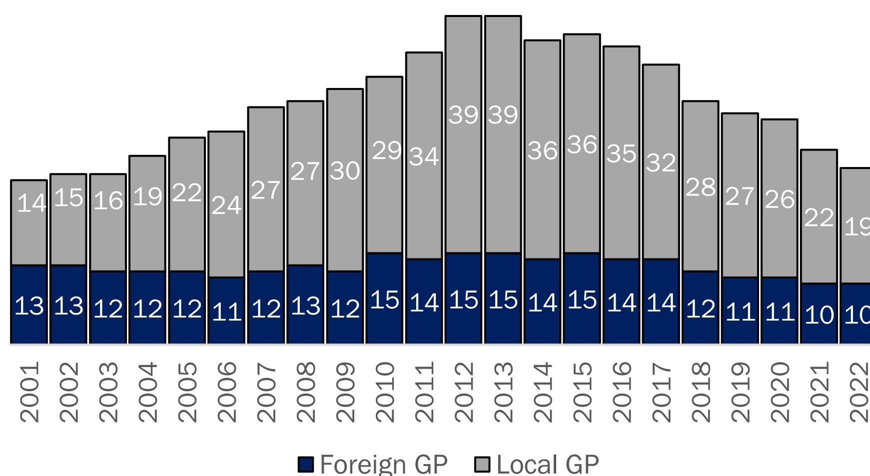
The following period between 2013 and 2016 was characterized by corruption scandals, and the Car Wash operation, which culminated in the prison of important businessmen and top managers, and eventually with the prison of the former president Lula in 2018. Despite the troubled political and economic environment, the number of PE fund managers stayed relatively stable, and the dry powder was not negatively affected.

President Dilma Rouseff's impeachment and Michael Temer's designation as the new president in 2016 were interpreted as a promising sign of political and economic stability. PE firms with funds in the end of their lives were able to raise new funds. However, new corruption scandals emerged including the Greenfield operation which investigated fraudulent investments by a few Brazilian pension funds. This hurt PE fundraising efforts with domestic institutional investors. Most of the frauds in pension funds' investments used FIP (the standard PE vehicle created by CVM - Brazilian Security Exchange Commission) as investment vehicle. Although the corrupted managers were replaced and PREVIC (Brazilian pension funds' regulator) worked with the pension funds on improving governance and controls to mitigate the risk of future frauds, pension funds shied away of investing in the PE asset class. This was a shame, since the vast majority of PE fund managers were reputable and ethical, and many of them had good track record.

Foreign investors also reduced new allocations in Private Equity in the same period. The Brazilian currency devaluation harmed the returns in US dollars of the PE investments, while in the US, the PE asset class performed extremely well thus increasing the bar for emerging market investments returns.

As a consequence of the events described in the two paragraphs above, we observed a reduction in the allocation of both foreign institutional investors and Brazilian pension funds to the asset class, and a shrinking in the number of active PE managers to 29, of which 10 are foreign and 19 are local houses.

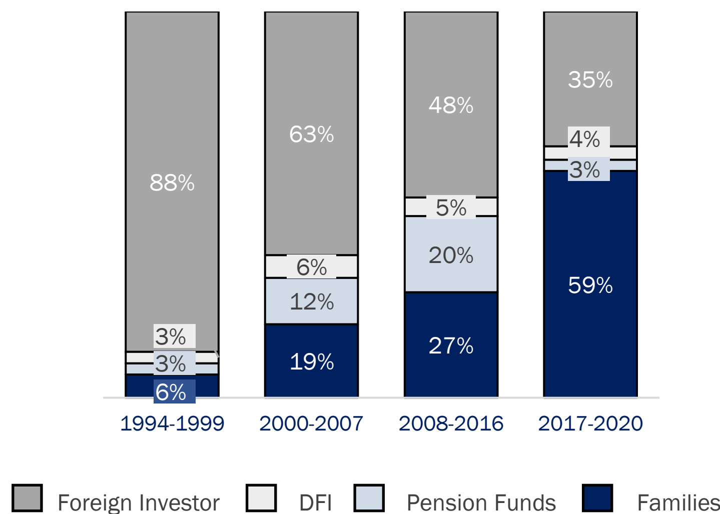
Figure 1. **Number of active Private Equity firms investing in Brazil**



The profile of the investors in Private Equity funds in Brazil has changed dramatically in the recent years. The percentage of foreign investors dropped from 88% of total fund raised in the 90s to 35% in the last decade. Pension funds were gaining relevance, and provided 20% of the capital between 2008-2016. Following the Greenfield operation, their representation decreased to only 3% of total capital invested in Private Equity while wealthy families have become the most relevant investors for Private Equity funds (Figure 2).

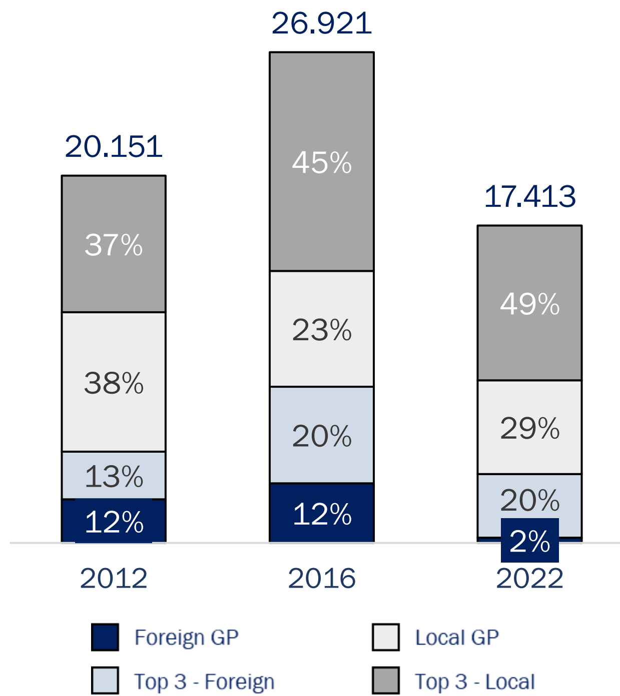
A previous article of Spectra and Insper analyzed the changes in the investors' profile in Brazil. Local families invest in BRL and experienced good performance in their illiquid investments since they were not subject to currency risk. Consequentially, there was an ever-increasing allocation in alternative assets by Brazilian families. Due to the events described previously, PE firms that had pension funds and foreign investors as their main source of funding suffered in the last four years. Furthermore, capital that could be allocated for PE thesis were assigned to VC and legal claims' funds. The Brazilian Venture Capital funds boomed, and experienced some exits with outstanding performance. Legal claims also became popular, with promising high returns and took part of the potential PE capital allocation.

Figure 2. **Private Equity investor profile**



Private Equity dry powder reached its lowest level of the last ten years. It increased from BRL 20 billion (USD 9.7 billion) in 2001 to BRL 27 billion (USD 7.7 billion) in 2016, and then decreased to BRL 17.5 billion (USD 3.3 billion) in 2022. The concentration of dry powder in the largest three local managers has increased over time. Those managers accounted for 37% of total capital allocated in PE in 2001, 45% in 2016, and 49% in 2022. The concentration in the top 3 foreign managers has also increased from 13% in 2021 to 20% in 2022. The representativeness of local GP except the three largest decreased from 38% in 2001 to 29% in 2022 (Figure 3).

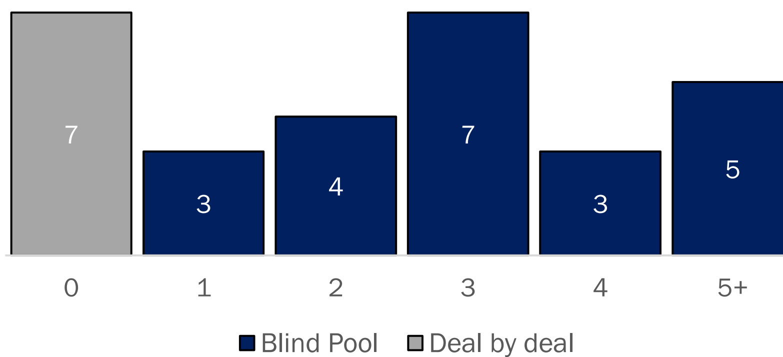
Figure 3. **Dry powder of Local and Foreign firms for Brazil (BRL million)**



As of 2022, only 22 out of the 29 active firms have raised blind pool funds and are in the investment period. Seven managers are making deal-by-deal investments, a path to create a track record to raise a blind pool fund. Only three managers are in the first fund, a worrisome figure as it represents a low renewal in private equity managers (Figure 4). Sixteen firms that are managing the portfolio or the current fund were classified as inactive, because they ran out of dry powder and did not raised any new funds. The probability that those managers will be out of the market in few years is high.

This picture clashes with the existing PE expertise in active managers' teams: without exception, all of the active firms have at least one partner with extensive experience in a Private Equity firm other than the current house. General partners (GPs) who are struggling to raise capital, and are doing deal-by-deal investments have, on average, nine years of experience in Private Equity. GPs in the first fund have 14 years of experience. Other active firms investing their second or higher order fund have an average of 17 years of experience in private equity and some of them had changes in the managing partners bringing the experience down.

Figure 4. **Number of active Private Equity firms and number of raised funds**



Past performance seems to be decisive for raising new capital. Firms that raised funds in the last three years, and are in an investment period, had previous funds with IRR and TVPI above the average of the corresponding vintage. PE Firms which are closed or inactive had funds with worse returns when compared to vintage return. The last fund raised by these managers has on average IRR BRL 9% lower (IRR USD 6% lower) and TVPI BRL 0.4x lower (TVPI USD 0.3x) than the vintage average. Previous funds of those managers also performed marginally worse (Table 1).

Table 1. **Average Return spread over vintage average return for active, inactive and closed Private Equity firms**

Panel A: Active firms				
	TIR BRL	TIR USD	TVPI BRL	TVPI USD
Actual fund	8%	6%	0,3x	0,2x
Last fund	12%	9%	0,7x	0,5x
All fund (excl. actual and last funds)	4%	3%	0,3x	0,1x
Panel B: Closed or inactive firms				
	TIR BRL	TIR USD	TVPI BRL	TVPI USD
Last fund	-9%	-6%	-0,4x	-0,3x
All fund (excl. last fund)	-1%	-1%	-0,1x	-0,1x

The return of Private Equity funds was overshadowed by the great decade of Venture Capital investments that have shown superior returns since 2009. However, Private Equity funds with 2016 vintage or newer showed improvement in IRR, and this may be an indication of bias of survival of the best backgrounds (Figure 5).

Figure 5. **Private Equity and Venture Capital IRR in Brazil by vintage (BRL)**

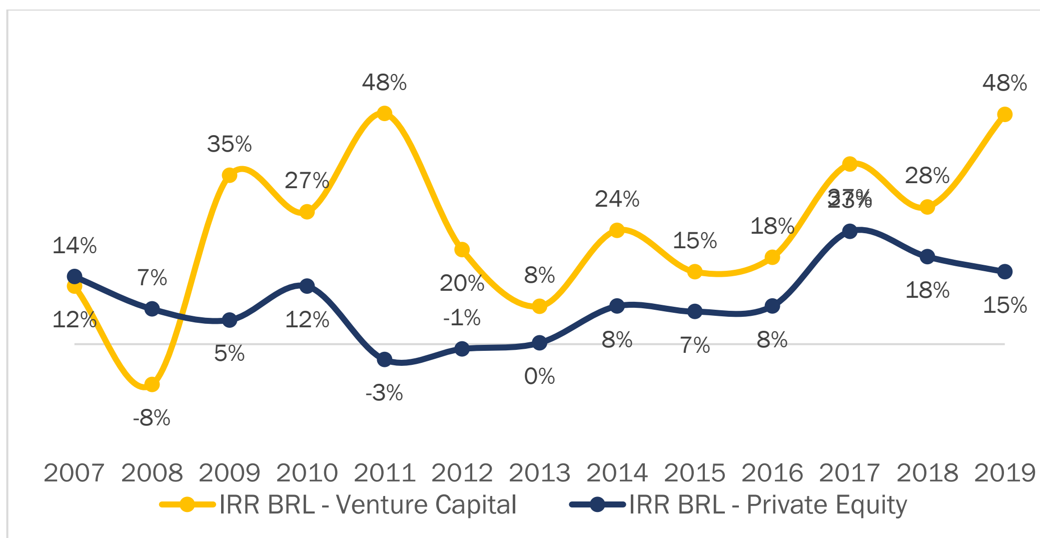
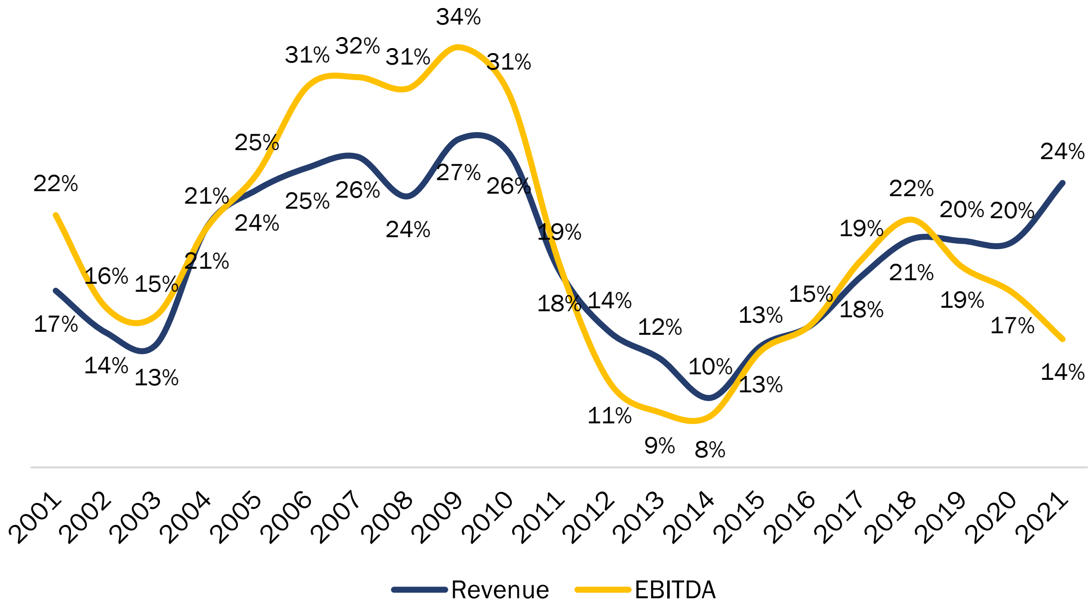


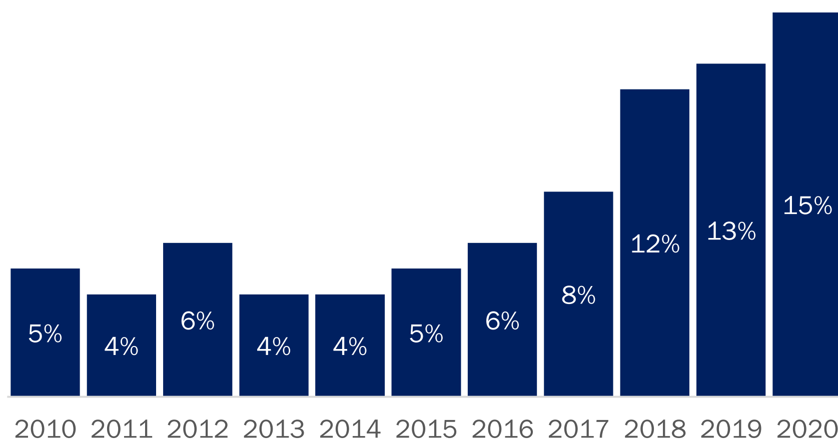
Figure 6 shows the real average annual growth in Revenues and EBITDA of Private Equity backed companies. To perform this analysis, we collected yearly Revenue and EBITDA information of each deal reported by managers of 337 invested companies, and estimated the average real growth[3] of Revenues and EBITDA in each year. Even in periods of economic downturn, PE invested companies grew an average of 10% in revenue and 8% in EBITDA. While in economic expansion, private equity backed companies EBITDA grew more than 25% on average by year.

Figure 6. **Revenue and EBITDA growth by year for Private Equity backed companies**



Private Equity firms are investing proportionally more in Tech companies: the share of investment in tech deals increased from 5% in 2010 to 15% in 2020 (Figure 7). This change has at least three main factors: 1) maturity of companies invested by venture capital funds, which reached size to receive investment from private equity firms; 2) the growth of tech companies is uncorrelated with economic growth, and also provides a sense of potential hedge against BRL devaluation; 3) Tech companies have exit multiples above traditional companies.

Figure 7. **Percentage of Private Equity investments made in Tech sector**



[3] Revenues and EBITDA were deflated by IPCA – a Brazilian inflation index.

CONCLUDING REMARKS

Private Equity has lost space in Brazil in recent years with the declining numbers of active firms and dry powder, and increasing concentration of dry powder in few managers. The managers that survived the last decade of economic and political instability were the managers with the highest return relative to competitors of the same vintage. These managers had also the ability to adapt to the new market tapping aggressively tech investments.

Brazil is characterized by a number of small and middle size companies that learnt how to navigate the troubled economic environment. Experienced private equity managers were able to create value and delivered excellent returns by helping those companies to establish the necessary governance, professionalism and processes to growth their business to a next stage. With the shrinkage of PE industry, we expect to see more opportunities than money available to fund them. Current active managers, which have extensive experience in PE, will be able to take advantage of lack of competition to select best deals and pay lower entry multiples. Therefore, it makes sense to expect that those PE vintages will have excellent returns, in a repetition of what we observed in the investments done during the nuclear phase of PE industry (1998-2002), when there were only a few active PE managers.