Private Equity in Latin America: Past, Present, and Future

Latin American countries were once the darling of private equity investors, but those markets have fallen out of favor because of a myriad of factors. This article examines the decline and what's ahead.

In 1595, with Queen Elizabeth's blessing, English explorer Sir Walter Raleigh embarked on an expedition to find El Dorado, the mythical city of gold. He promised the queen he would find a "gold-rich empire," but the men on his expedition to the Orinoco River basin never found the fabled city. Like dozens of other expeditions for El Dorado conducted by conquistadors throughout the 16th century, the quest for easy riches in Latin America proved to be a mirage for Raleigh, and he returned to England with tall tales but no gold.

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Modern-day private investors may not be chasing legends of golden cities, but after a decade of heavy investment, international private equity funds are divesting from Latin America. Following the global financial crisis in 2008, international investors looked to emerging markets such as Latin America for potential opportunity and returns, according to Bloomberg. The region was in the middle of a commodities boom and seemed poised for strong economic growth. "In the 2000s, more than 80% of [emerging markets] enjoyed faster growth in output per person than the United States, up from 34% in the 1980s," according to *The Economist*.

Major international private equity firms, such as Carlyle, TPG Capital, KKR, and Ajax Partners, quickly opened offices in Latin America between 2008 and 2013 to capitalize on the attractive investment environment, according to Bloomberg. In September 2010, Blackstone acquired its inaugural Latin American transaction through its acquisition of a 40% stake in Patria, a leading asset management firm in Brazil.

However, by the late 2010s, the commodity boom had come to an end and economic tides began to turn for these institutional investors looking for strong growth potential in the region. Blackstone, TPG, KKR, and Ajax Partners have all since closed their Latin American offices. Blackstone reduced its stake in Patria to 14% through its IPO in January 2021, according to Reuters, and Carlyle announced it would no longer raise exclusive Latin America funds, according to Bloomberg. With 2021 fundraising at a fraction of prior years and large-scale divestitures reaching a five-year peak, according to Bloomberg, the future does not look bright for institutional private equity investment in Latin America.

These international private equity firms are scaling back on their Latin America strategy as the region continues to present challenges including slowing macroeconomic growth and political volatility, smaller transaction sizes limiting overall deal flow, and currency devaluations. However, prudent local investors continue to pick their spots to identify mid-market opportunities for growth and drive strong risk-adjusted returns in the seemingly perpetually volatile region.

Slow Growth and Political Instability

Latin America's challenging investment environment has been defined by slower macroeconomic growth and political instability. While the region is not monolithically protectionist, leftist political trends and anti-business policies contribute to increased uncertainty and risk for investors. During the 20th century, most of Latin America had protectionist economic policies restricting international trade to drive growth of domestic industry. During the 1980s and 1990s, a wave of deregulation across the region opened capital markets to investors, but market liberalization was followed by a leftist backlash against open market policies. These trends continue to give investors pause, with political leaders who support anti-business policies gaining traction across the region, according to *The Economist*.

Much of the political volatility stems from perennial discontent about macroeconomic growth. Since 2010, Latin America's three largest economies (Mexico, Brazil, and Argentina), have been largely in decline, according to the World Bank. Real GDP per capita also decreased over the decade, according to the World Bank, contributing to a widening perceived gap in standards of living between citizens of Latin America and other countries such as the United States. Discontent over the status quo has resulted in the emergence of populist leaders, such as Andres Manual Lopez Obrador in Mexico, Jair Bolsonaro in Brazil, and a return to power of the Kirchner coalition in Argentina, bringing challenging policies for business. Slower economic growth continues to put pressure on the governments to increase revenues to pay for social services, exacerbating the environment for business as they bear the burden of these tax policies that cut into their profits.

Dynamic populist leaders raise the chance of aggressive action against companies on the wrong side of the ruling coalition. The risk of increased taxes and reduced trade creates risk for investors, who are nervous to park their money in countries with uncertain futures. In addition to the political risk, the lack of macroeconomic growth itself limits the returns investors will likely receive as companies fight for market share of a shrinking pie. Investments in Latin America present higher risk with less upside relative to larger, developed economies. Within this framework, it makes sense that large funds and international investors would take their money elsewhere, leaving Latin America to smaller or country-specific funds that have deep insight into macroeconomic and political trends within their respective countries.

Too Big Not to Fail

In many ways, the success of private equity funds in raising capital in the 2010s contributed to later difficulties. The cornerstone of many of these large institutional firms is their differentiated ability to efficiently deploy massive amounts of capital in large, complex transactions. Like most emerging markets, however, transaction size is limited in Latin America due to the muted size and growth of its economies. The result is a much thinner pipeline of sizable deals that meet minimum ticket size requirements. Larger firms thus have less optionality and need to make significant trade-offs when evaluating deals in the region. Met with pressure to deploy capital within their investment period, funds may invest in companies they might otherwise avoid, taking on additional risk that predictably leads to disappointing returns. For example, Southern Cross Group, an Argentina-based fund with a historically strong track record, faced this challenge after raising a $1.7 billion fund in 2010, according to Private Equity International, which created incentives to quickly deploy capital into larger, less attractive deals that ultimately yielded poor results.

Because the largest firms get the most headlines, the reporting on the shift away from Latin America hides the fact that some regional and middle-market funds continue to do well. Middle market funds focus on transactions in the $50 to $150 million range, which offers a larger pool of deals to evaluate. With a strong pipeline and more optionality, these firms can be more selective and prudent in their investment process. To hedge against the volatility of the region, successful funds are also more conservative in their financing and place a premium on improving the core operations of their companies rather than boosting returns through leverage.

Given the size of Latin American economies and resulting dealflow, firms are also limited in their ability to specialize by industry despite investor preferences in some cases. Limited dealflow within any given sector suggests that firms cannot justify completely specialized funds and must maintain generalist knowledge of the region as a whole. Thus, private equity investors in Latin America face a peculiar challenge to maintain a breadth of knowledge across sectors while developing expertise to evaluate these transactions. This incentivizes funds to opportunistically pursue deals across a wide variety of industries, which can make it harder to effectively evaluate the quality of a company in an industry they are less familiar with. As a result, local knowledge and strong industry relationships have become critical differentiators for successful firms to generate strong returns in the region.

This has significant implications for a different segment of the market: venture capital. The speed and scale of venture capital growth in the region mirrors the dynamics of private equity growth in the early 2010s. But if these venture capital firms are to be successful, they should look to the lessons learned by the Carlyle Group, Blackstone, TPG, KKR, and Ajax Partners. Bigger is not always better.

Currency Kills

Currency volatility is another headwind for private equity funds in Latin America. Throughout the 20th and early 21st centuries, Latin American currencies have been subjected to speculative attacks and sharp devaluations, and the past decade has been no exception. To give a few recent examples, the Brazilian real, the currency of Latin America's largest market, has depreciated against the dollar every year since 2011, falling 22% in 2020 as the government initiated several stimulus programs, according to Bloomberg, while the Argentinian peso has experienced a 96% devaluation against the dollar since 2010, according to data on XE.com.

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While economic theory suggests that over the long run companies could raise prices to adjust for inflation and ultimately mitigate currency impact on returns, in reality, private equity funds must deliver returns within their five-year investment horizons, making it virtually impossible to perfectly align exit strategies with currency upswings. Therefore, currency fluctuations and inflation create additional risk and potentially reduce returns, requiring larger capital investment to drive alpha and compensate for losses.

Conclusion

While anemic macroeconomic conditions, political volatility, market size, and currency fluctuations continue to present challenges in the region, savvy mid-market funds focused on Latin America continue to find attractive growth opportunities. In some instances, currency devaluations benefit investors that are able to capitalize deals at an attractive basis. According to Tim Purcell, founder and managing partner of Latin America-focused fund Linzor Capital, when "currencies are devalued, and macroeconomic growth decreases, the entry point into the market is lower, leading to more upside potential." Business owners, Purcell also noted, are more likely to sell during currency devaluations due to liquidity constraints, which increases dealflow.

Additionally, certain industries in the region seem particularly promising. For example, Purcell shared that non-banked financials are attractive given Latin America's large unbanked population, and the education sector is enticing due to the opportunity to invest in educational institutions that provide value-for-money to first-generation university students. With the appropriate industry focus and opportune investments decisions, there are still plenty of growth opportunities for private equity firms in the region, and it will only be a matter of time before Western investors return, again in search of the metaphorical Latin America city of gold.

This article was written by Adriel Barrett-Johnson, Brandon Rollins, Camille de Ry, and Tim Jacobs, members of the Lauder Class of 2023.

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