. . . as appeared in . . . Published by *WorldTrade Executive, a part of Thomson Reuters*

LATIN AMERICAN
Law & Business Report

Volume 19, Number 5 **May 2011**

Top Ten Trends for Latin Investment Funds

By Alyssa A. Grikscheit, Ina M. Drago Ludowieg and Bruno Pierin Furiati (Sidley Austin LLP)

A February article in The Economist proclaimed Brazil "this year's hot market for private-equity firms and hedge fund managers".[1] Brazil emerged relatively unscathed by the global financial crisis, and in terms of market size and political risk is proving attractive to investors such as Carlyle Group that had typically not focused on the country or the region in the past. Nor is Brazil alone. Legal reforms and GDP growth in Colombia and Peru, among others, have brought these markets to the attention of new investors seeking to form private equity, credit, hedge, infrastructure and real estate funds to capitalize on the expected growth of investment opportunities in the region. According to the Latin American Venture Capital Association, private equity funds raised a record high of $8.1 billion for Latin America in 2010, a 122% increase over 2009.[2] At the same time, private equity investments quintupled on a year-over year basis to $17.2 billion.[3] Assets under management by hedge funds also increased. For example, assets under management of Brazilian hedge funds increased 23% over the same period, to reach a total of $243 billion in that country alone.[4]

But no matter how experienced an investor may be in other markets, both forming a fund for making investments into Latin America and structuring such investments have unique challenges, as set forth below.

Location, Location, Location, Part I – Be Flexible on Fund Location

New and existing fund managers typically have a set of jurisdictions they are comfortable evaluating and comparing when deciding to form a new fund. The decision as to the best jurisdiction for a new Latin fund needs to factor in tax considerations, reporting requirements, investors being targeted in fundraising, and countries for investment. Moreover, the same structure that may work for other markets may not necessarily be the best one to replicate for Latin America.

The default for some advisors is to start with Delaware as a jurisdiction for a new fund. This can be an attractive jurisdiction for funds investing in Brazil, as described in more detail below, but many European investors fear that a change in law might somehow submit them to U.S. taxation and prefer to avoid the jurisdiction for mostly psychological reasons.

Although familiar for European investors, many European jurisdictions such as Luxembourg can be cumbersome and expensive. Luxembourg funds must be registered with the Commission de Surveillance du Secteur Financier (CSSF), which adds additional time and cost to the fund formation process. Dutch, Irish and UK funds all have their proponents, but the European Commission, through its proposed Directive on Alternative Investment Fund Managers, has raised fears on the part of new managers of unnecessarily submitting themselves to additional regulation.

Although less commonly used, Canada has been a good jurisdiction for forming funds investing in Latin America, but recent regulatory changes have meant that more offshore fund advisors forming Canadian investment funds will need to register as Canadian investment advisors, particularly if their investment strategy is not a pure private equity strategy.

Location, Location, Location, Part II – The Good, the Bad and the Ugly of Offshore Jurisdictions

A solution to the problem of where to form a fund may be to form it in an offshore jurisdiction. The Cayman Islands is the offshore jurisdiction where most funds are currently being formed for investment into Latin America. The British Virgin Islands used to attract some cost-conscious new fund advisors, but certain incoherent investment advisor registration rules have led many British Virgin Islands funds

---

Alyssa A. Grikscheit is a partner at Sidley Austin LLP. Ina M. Drago Ludowieg and Bruno Pierin Furiati are lawyers at Sidley Austin LLP. All three are based in the New York office. Alyssa is admitted to practice law in New York, Ina is admitted to practice law in Peru and Bruno is admitted to practice law in New York and Brazil. Sidley Austin LLP does not provide advice as to matters of Peruvian or Brazilian law and the authors are not authorized to practice in other jurisdictions.

to reincorporate in the Cayman Islands as a more fund manager-friendly jurisdiction.

This, however, is not the end of the analysis for investors focused on investing in Latin America. For funds concentrating on Brazil and Mexico, for example, investing through the Cayman Islands has certain adverse tax consequences. The Cayman Islands, like 64 other offshore jurisdictions, is considered a "tax haven" by Brazil, which imposes an additional 25% withholding tax on funds coming from this jurisdiction. This has led to a move away from Cayman funds for vehicles focusing on Brazil, many of which are formed in Delaware, with a view to its predictable rules and relatively low costs. A similar dynamic applies with respect to funds focused on investing in Mexico.

Location, Location, Location, Part III – Go Local?

Recent legal reforms have allowed pension funds in certain countries to invest in private equity and other asset classes. These reforms, combined with declining interest rates (and therefore declining returns) on their fixed income investments, have led to increased demand on the part of local pension funds for solid funds managed by reputable fund managers in which to invest. By way of example, as of September 2010, Peruvian pension funds are now permitted to invest 30% of their assets in private equity and there is some discussion of raising this limit further to 50%. Chile's pension funds may invest up to 80% of their total assets in private equity. The need to diversify has led pension funds to become more comfortable than most other local investors with delegating investment authority to a third party pursuant to a fund structure.

This demand in turn, has occasionally turned the jurisdictional analysis on its head. Sometimes the best location for a fund is in the location of investment. Brazil has established the "Fundo de Investimento em Participaçãoes" or FIP which provides for certain tax benefits for international investors not located in tax haven jurisdictions. Under current Brazilian law, an international investor owning an interest of less than 40% of a FIP has a 0% withholding tax, as compared with a 25% withholding tax for investors based in tax haven countries. Moreover, Brazilian pension funds are only permitted to invest 10% of their assets abroad, such that a FIP structure is more likely to attract their investment.

Investors targeting Colombian pension funds are also forming "Fondos de Capital Privado" or FCPs in order to attract the investment of such pension funds as core investors. Mexican pension funds are now able to invest in private equity, but with very few exceptions, they can do so only through a heavily regulated structure which has had mixed results in attracting new managers to form Mexican domiciled funds.

Parallel Funds and Co-Investing

As mentioned above, it is becoming more common to form specific vehicles to cater to local pension funds. Yet coordinating such vehicles with offshore vehicles raises special challenges. In some markets, master-feeder structures are not common and parallel funds must enter into co-investment or parallel investment agreements to ensure coordinated investment and divestment, among other decisions to be taken jointly. Such joint decision-making may be subject to certain limitations and norms in the applicable countries. Sometimes the local fund co-invests with a regional fund with a similar structure. To complicate matters further, certain offshore investors often insist on special co-investment rights, further complicating the mechanisms and structures of each investment transaction.

The Dollar, the Peso, the Real

Most Latin American funds are denominated in dollars, particularly if they have a regional investment strategy. But the move toward local fund vehicles, as described above, has led some pension funds and other investors to demand that new funds be denominated in local currency. Many new Colombian funds are denominated in pesos. This then raises additional complications when the offshore fund investors seek to invest in dollars. Often local investors want the offshore investors to bear the risk of any currency fluctuation, but offshore fund investors may view certain fund structures as unduly shifting risk in a context where there is already local currency and political risk.

From time to time, certain countries have also implemented exchange controls, taxes on foreign exchange or other measures. These have primarily been directed at dampening the effects of short-term currency speculation, but have typically affected long-term investors as well. For example, Brazil's tax system is structured in such a way that the Brazilian Federal Government can increase its tax on foreign exchange transactions (IOF) at any time in order to prevent the appreciation of the real associated with speculative capital inflows.

The Three Musketeers: Targeting Development Banks

Development banks have been an important part of the investor base in most of the successful funds investing in Latin America. They are typically reluctant to invest in a first closing and with unproven managers. Negotiating with development banks can be very thorough and time-consuming and while two or three development banks often invest together, their diligence requests and internal requirements need to be coordinated to make the resulting fund structure workable for the fund manager. Development banks also have additional social objectives and investment requirements, including investment codes and additional environmental reporting, which may increase a new fund's compliance burden. However, attracting development banks as investors can have very real benefits: these investors typically have very long-term outlooks and virtually no history of defaults on capital calls. Some of them, such as the Brazilian Development Bank (BNDES), have special credit lines and co-investment mechanisms for private equity investments.

The Majority, the Minority… and the Family

In many countries in Latin America most of the middle market and larger companies are controlled by families. This complicates the usual calculus that investing in control transactions is better than investing in minority interests, because control investments can be hard to come by. In addition, there is additional pressure on negotiating minority rights and coming up with a structure that decreases the risk of having to invoke such rights. This is because enforcing minority rights in court in most Latin American countries can be a very long-term proposition, possibly longer than the entire investment time horizon. Aligning incentives with the majority and other family stakeholders therefore becomes paramount in order to reduce as much as possible the need for resorting to litigation. Sometimes like-minded minority investors act together to have stronger rights than they might have individually. Other minority investors invest only in businesses that have strong cash flows and are expected to make distributions during the investment term, in order to reduce the relative importance of the exit at the end of the transaction. Still other investors focus on offering debt alternatives to attractive family businesses in countries with little or no cost-effective financing in local currency for such businesses.

Head for the Hills - Exit Planning

It is critically important to plan for various exit possibilities at the outset when investing in Latin America. While the IPO markets in several countries, notably Brazil are robust, only a small percentage of exits can realistically take place through public offerings. For example, in Colombia, 63% of exits are currently through a direct sale to a third party, and only 13% through an IPO.[5] This ratio may change with the integration of the stock markets of Chile, Colombia and Peru into the Latin American Market (MILA), which will have a market capitalization of over $600 billion, thereby becoming the region's second largest exchange after that of Brazil. However, the fact remains that other exit alternatives will be needed.

In order to maximize the chances of a successful exit, fund managers need to ensure that they are investing in industries that will be attractive to both strategic and financial investors in order to have a full range of exit alternatives available at the appropriate time. Furthermore, investing in portfolio investments through holding companies can improve structuring options on exit for potential buyers who do not want to buy stock at the local level. Built-in buy-sell provisions or other mechanics at the portfolio level can also help ensure an exit at the appropriate time.

Clawbacks, Defaults and Other Bad News

Fund managers must also plan for the worst. Limited partner clawbacks are standard in most U.S. and European fund documentation, but are foreign to many Latin American investors. Fund documents should provide for clawbacks in case amounts are distributed to investors prematurely, as the only other option is for the fund manager to hold significant reserves, thereby bringing down investment returns.

The global financial crisis saw more defaulting limited partners, and in the case of Latin America, secondary trading of fund interests is still somewhat limited. Fund managers with liberal cure periods found themselves waiting to call defaults in cases where cure was not possible, and as a result managers raising new funds are tightening the default provisions.

Fund managers need to keep up to date on more minor changes and variations in the legal landscape as well. Changing regulations in various countries may trigger the need to reassess such matters as fund manager registration, confidentiality of investor information, or other matters. Anti-money laundering requirements also keep shifting. Some countries will "look through" certain jurisdictions and seek information about the fund's investors that may run counter to investor expectations or fund manager promises. Another example of a look-through provision that can potentially complicate investments by private equity funds is the Brazilian antitrust law, which may take into account the size of the investors in the fund (including their Brazilian revenues) in determining whether reporting is required.

Fund II and Beyond

While certain seasoned international players in the region are well beyond Fund II, it bears mentioning that many newer and often locally-based players are reaching capacity on Fund I and moving on to Fund II. They do so at an auspicious time. Peru has had more than ten years of year-over-year GDP growth in a row. Colombia's debt recently returned to investment grade after an 11 year hiatus. And Brazil is the undisputed darling of emerging markets investing. Growing middle classes are fueling increased consumer demand, new local investors led by the private pension funds are seeking funds and deals, intra-regional integration is increasing, demand from China is broadening beyond the traditional commodity sector and in the case of Brazil, the advent of the 2014 World Cup and 2016 Olympics are increasing the demand for complex infrastructure projects. All this means that the fundraising and investment climate outlook is quite positive for countries that keep internal conflicts under control, manage political transitions appropriately and keep engaging in legal reform.

---

1 "The buys from Brazil," The Economist (February 19, 2011) at 81.
2 Available at: http://lavca.org/2011/03/21/private-equity-funds-raise-a-record-8-1b-for-latin-america-in-2010/
3 "2010 Year-End Report," Venture Equity Latin America.
4 The Economist, supra note 1 at 81.
5 Guia Practica de Fondos de Capital Privado para Empresas, Convenio Colombia Capital – Bolsa de Valores de Colombia (July 2008).

Reprinted from *Latin American Law & Business Report*
©2011 Thomson Reuters
www.wtexecutive.com