IESE Business School
University of Navarra

E-115-E
0-608-015
Rev. 11/08

Southern Cross Latin America Private Equity Fund

> "When we started the firm and began talking with investors in 1996, the challenge we faced did not relate to issues about the Latin American markets but to questions about our investment strategy and lack of a track record in private equity. We were confident that our approach to private equity investing would work, but it was contrary to conventional wisdom. Also, although Norberto and I had known each other for some time, working together as partners would be new for us. Now we have demonstrated that this investment strategy works, and our track record speaks for itself."

Ricardo Rodriguez was reflecting on how he and his partners built Southern Cross Group, one of the leading private equity firms investing across Latin America. Reflecting the backgrounds of the founders, the Southern Cross strategy followed three courses that were not typical of most other private equity firms. First, rather than constructing a broad portfolio with lots of investments – usually construed as a kind of hedge against the high risks of investing in private companies – Southern Cross invested in only 5-7 companies in a fund. Second, Southern Cross played a more active role than most private equity firms in supervising the management of portfolio companies. Finally, unlike traditional buyout firms, Southern Cross used little to no leverage when investing in a company.

This case was prepared by Professor Rob Johnson as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. September 2008. Revised in November 2008.

Last edited: 11/21/08.

Now going out in October 2006 to raise its third fund with an increase in capital of more than three times the prior fund, the Southern Cross partners faced questions about whether this strategy still made sense for the firm and its market.

The Latin American Market

In the mid-to-late 1990s Latin America was suffering from a major financial crisis. While it began as spillover from an Asian financial crisis, the crisis in Latin America was exacerbated by fiscal problems in some Latin American countries and the 1994 currency crises in Mexico, all of which spilled over to other Latin American countries. In hindsight this crisis was a kind of wake-up call for the region, as political leaders began to realize that financial reforms were essential if their countries were going to build truly robust economies. 1996 saw the start of such reforms in the region.

Latin America was home to 480 million people, 8.5% of the world's population; yet GDP for the region of $4,274 per capita was less than one quarter of the average for developed nations. Further, GDP growth in 1996 was relatively low at 3.5%, while unemployment had risen to a high mark of 7.7%. Domestic interest rates had been persistently high, inflation had been a continuous worry, and economic growth was a major concern everywhere in the region.

Yet there were the beginnings of positive signs in 1996. Inflation in Latin America fell from 26% in 1995 to 18% in 1996 and looked set to continue that trend. Within the region, the economic situation varied. In Chile and Peru, for example, GDP grew significantly in 1996, while Mexico and Argentina experienced severe GDP contraction. However, it was indicative of the force for reform that the latter two countries were among those that put their financial systems on a sounder footing beginning that year. The conclusion to a United Nations report published in early 1997 described "an attitude of cautious optimism" about the economic future of the region. There were also positive signs about future increases in foreign investment in the region, including private equity capital.

Private Equity in Latin America[1]

In the 1990s the institutionally-backed market for private equity investments in Latin America was still young, with a relatively small number of firms active there. At the same time, the high level of liquidity in the world had led to increased interest from investors seeking higher returns in riskier markets, and a number of US and international funds set up offices in Latin America. The region had three categories of private equity firms: very large family groups who invested for strategic as well as investment reasons, local country funds run by local managers, and regional funds primarily headquartered in or sponsored from the US

[1] Much of the material in this section is taken from IESE note EN-6-E, *Assessing Non-US Markets for Private Equity Investments* by Prof. Rob Johnson, Feb. 2006.

The private equity industry in Latin America developed on the back of privatizations in the early 1990s, with country funds forming shortly thereafter and regional funds entering the region in the mid 1990s. Capital flowing into the region, mainly from US pension funds and insurance companies, peaked in 1996-1998 and then, reacting to the economic instability in the region, fell dramatically, resulting in a smaller number of private equity firms remaining in the region.

In addition to privatizations, buyouts and expansion capital deals dominated private equity transactions, with firms usually taking majority positions in deals. While lenders piled into some transactions in the mid-1990s, the lack of developed capital markets and the volatility of lenders meant that appropriately structured leverage was not readily available for most transactions. Similarly, because of the lack of stable public markets, most exits from private equity investments had to be achieved via trade sales, though there were increasing IPOs on US stock markets that included a local listing in selected Latin American countries. Overall, growth in the private equity market in Latin America had been limited, and there were only a handful of firms operating there with meaningful track records and the capability to take restructuring or growth situations forward.

Despite the outward appearance of a more homogenous region than Europe or Asia, private equity investments in Latin America were very different from country to country, with only a few cross-border deals being done. The availability and quality of managers, capital markets, and stock markets were only a few examples of factors where differences among markets were significant. Most private equity activity in Latin America was focused on four countries: Brazil, Argentina, Mexico and Chile.

With its big economy and indigenous entrepreneurial flair, Brazil generated a fair number of private equity deals on a regular basis; however, many of these deals were minority investments with limited influence over management. Government policies had generally been realistic and business-friendly, the local economy became less volatile, and the business community benefited from a pool of competent businessmen, all of which made the country attractive for private equity investments. Generally, the investment process in Brazil was not particularly efficient, so competition for deals was not very high.

Private equity poured into Argentina early, attracted by its educated workforce and good infrastructure as well as impending privatizations; however, later continuing economic instability following the 2001 financial crisis and the ensuing collapse of the Argentine economy took its toll on the industry. One result was lots of distressed business assets owned by banks, along with weak capital markets and government solvency issues. This situation produced some interesting investment opportunities, but also a high level of uncertainty for private equity funds.

Chile made essential economic reforms earlier than most other Latin American countries and had a sound financial infrastructure. Yet given its relatively small population and the fact that many companies were controlled by a small number of families and conglomerates, Chile produced only a few investment opportunities for private equity firms. The fact that transactions in Chile were typically more transparent than in many other places and the expertise and financial strength of local groups also made Chile a very competitive market for the few deals that were available.