Privcap/Briefing
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Investing in Brazilian Real Assets

An executive summary of the Privcap thought leadership series on the private equity opportunity in Brazil

Plus:

Expert Q&A with Gustavo Gusmao,
Executive Senior Manager,
Lead Advisory – Public Sector – EY Terco

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Investing in Brazilian Real Assets

Key Findings

1. Surging demand—is creating infrastructure gaps—and opportunity for private capital
2. Government officials can be critical partners in deal flow and investment success
3. Community relations are vital in real-assets investing
4. International capital needs local partners and expertise
5. Debt financing for real-asset investments is not easily sourced

Amaury Junior
Founder and CIO
Vision Brazil Investments

Gustavo Gusmao
Executive Senior Manager of Infrastructure Advisory for the Public Sector, EY

Victor Munoz
Managing Director
Denham Capital Management

1. Surging demand is creating infrastructure gaps—and opportunity for private capital

Per capita GDP in Brazil has grown an average of 18 percent per year over the last decade. Infrastructure development has not matched that pace and, as a result, there are significant gaps in the economic landscape. These are attractive opportunities for private capital.

Take the power sector. "All the forecasts indicate that Brazil will have to add around four to five gigawatts per year over the next five years," said Victor Munoz, whose firm, Denham, invests in power generation, among other things. "We're talking about 20 to 25 gigawatts of additional capacity that needs to be built, and there's going to be a need for equity investment to do that."

He illustrated the magnitude of the opportunity by pointing to the power sector in nearby South American nations. Chile has a generating capacity of just under 16 gigawatts, Peru around nine gigawatts. "Add Peru and Chile and you're still smaller than what Brazil will have to build," he said. "So the size of the opportunity is really interesting."

Two other sectors where demand is driving infrastructure growth—and opportunity for private capital—are ports and railways. "These two are really important to reduce the cost of transportation in Brazil," Gusmao said. "In Brazil, transportation is still pretty much based on road infrastructure, and there is a realization that new investments need to be more focused on rail and ports. And for that, the private sector is starting to take a closer look at programs the Brazilian government is releasing."

2. Government officials can be critical partners in deal flow and investment success

Government can be—often must be—an ally for private equity firms in infrastructure deals. Amaury Junior's firm, Vision Brazil, is currently considering partnership with the government in northeastern Brazil, where Vision has invested extensively in farmland.

Logistics in the region are so rudimentary that it's cheaper for people in coastal areas of northeastern Brazil to buy grain shipped in from overseas than to buy grain grown on farms to the west, where Vision's farms are located.

Vision is studying the possibility of bridging—and leveraging—that gap by partnering with the government. "The government is in the process of developing several new railways," Junior said. "In the northeast, there is one that we are looking at very closely, which is the Trans-Northeast Railway. There are tremendous opportunities for the private sector to piggyback on government investments in the layout of infrastructure."

Of course, care must be taken when it comes to rates of return floated by any government. "The market is really concerned about the rate of returns," Gustavo Gusmao of EY said. "If you're looking for more return, even though you will assume more risk, at the end of the day the government is trying to regulate too much on the rate of return. This is a concern of the market. But I think at the end of the day the government will realize they need to be more flexible, just to foster better competition for these projects."


Amaury Junior

Watching the Regulators

Even the best-crafted deals can unravel, especially when the government introduces unexpected regulations that dissolve your investment thesis. It's happened to Vision Brazil.

The firm spent years building a portfolio of agricultural investments in Brazil, including 16 large-scale farms. Then, in 2010, the government introduced new laws that placed a cap on foreign ownership of Brazilian land.

"When this new regulatory framework came into place, we got concerned about the exit opportunity, because it restricts the buyers of agricultural land," said Amaury Junior of Vision Brazil.

With farmland everywhere at a premium, however, Vision Brazil has been able to exit farm investments, in spite of the government regulations. Five years ago, for instance, it bought a large but struggling farm. It improved operations and increased production and recently sold it to Brazil's largest soybean producer for a tidy profit.

"This was an amazing investment," Junior said. "On an unleveraged basis, it was about a four-times return. On a leveraged basis, it was close to seven times."

Expecting the Unexpected

Sometimes private equity opportunities soar. Other times they can't get off the runway. That was the case with Brazil's recent airport construction projects.

"There was a lot of attention from the private market, but also a lot of challenges," said Gustavo Gusmao of EY. About 10 private equity consortiums bid on the airport project—but in the final stages the government changed a major requirement.

Two months before final proposals were due, government regulators insisted that every consortium bring on an international partner with a strong track record in airport operations. "At the end of the day, some of the consortiums were not able to meet this requirement at such short notice," Gusmao said.

The lesson, Gusmao said, is that firms bidding on public projects should be prepared for any contingency. "Of course, you don't know the final requirements. But you have to have a jump start in terms of assessing these projects. Otherwise you're going to be much less competitive than the other players."

3. Community relations is vital are real-assets investing

Every investment demands due diligence back at headquarters. But it goes for naught if the deal is mishandled on the ground. This is especially true of real-asset investment in Brazil, where locals keep a close eye on their natural resources.

Munoz's firm, Denham, is heavily involved in mining. And every mine Denham develops is prepped with outreach in the community. "You go and drill to see if the commodity is in the ground," he said. "And people see the cars, the trucks, with the logo of your company. If you don't address the community and tell them what's going on, most probably the community is going to wonder, 'What are all these trucks doing here? Are they taking away our stuff?' "

So it's crucial to involve someone local who knows the culture and speaks the language to engage the community and explain the project and its benefits, such as employment, development, tax money for schools, etc. This often happens at the numerous permit hearings required of mining projects in Brazil. A firm can make good use of them if it has an active plan for public relations.

"In doing that, you prevent negative assumptions about your project," Munoz said. "The community understands what you're doing, that it's good for them. In the end, your community is going to be your partner."

4. International capital needs local partners and expertise

Brazil is a fashionable destination for capital, attracting interest from investors around the world—from private equity funds, pension funds, and other international players. They're especially interested in infrastructure, but they can't simply parachute in and start operations. Successful deals require local partners.

In the agricultural sector, it's a legal requirement. In 2010, Brazil tightened a law limiting foreign ownership of farmland in rural municipalities. But local partnerships come with an upside in many asset areas, including agriculture: They help grow successful deals.

"It's very healthy in the sense that the expertise of production tends to be more among the locals," Junior said. "And it varies a lot by region, so the expertise in a certain region does not necessarily apply to another region. That's what we learned from the perspective of doing investments. The approach for agriculture has to be really focused on local expertise."

5. Debt financing for real-asset investments is not easily sourced

Financing for infrastructure in Brazil is dominated by the Brazilian Development Bank, BNDES. "This has been the case for many years," Gusmao said. "And I believe for the near future they will keep being the main lender for infrastructure."

"And getting money from BNDES is not easy," Munoz added, particularly in the energy sector. "Quite frankly, project financing from BNDES for the power sector is unlike other project finance in Brazil, where the lender looks at the merits of the project only and, if it's satisfied with the merits, it lends the money. where the lender looks at the merits of the project only and, if it's satisfied with the merits, it lends the money. BNDES doesn't do that. They require guarantees that have to be provided from a balance sheet, from a power company, from others. It's not true project finance in that sense."

BNDES has a number of stipulations, including a minimum level of local participation. If the project is a wind farm, for example, the turbines and towers must be made in Brazil. "Your project could be the most sound financial project," Munoz said. "But if you don't meet those local-requirement thresholds, you don't get access to the financing. So it is in the case of the power sector: Understanding BNDES is paramount in understanding how to get there. And sometimes that road is complex."

Victor Munoz

Applying the Three-Step

How do private equity firms in Brazil identify the best opportunities? "We take a three-step approach," said Victor Munoz of Denham Capital. "First we look at theme, then we look at team, then we look at the actual deal itself."

One of Munoz's favorite macro themes is energy, including power generation. "Once we confirm that's the place where we're going to focus, we go to the second step, which is team," he said.

For Munoz, that means finding the best local entrepreneurs with deep knowledge of the specific region where they're operating and a long list of local contacts. "That takes a lot of time," he said. "You walk around, you meet people, until you finally find that management team."

Then he does the deal. And if there's no company available at the moment, he creates one. "If it's in power, we create a company, and then we go develop power projects or invest in other power projects," he said. "As for the actual execution, that's all about being local—understanding the culture, understanding the way of negotiating, and understanding the regulations."

Expert Q&A

with Gustavo Gusmao,
Executive Senior Manager,
Lead Advisory – Public Sector – EY Terco

In addition to your financial advisory work, how else do you help real-asset investors find success in Brazil?

Not only do we provide financial advisory for our clients, but we also aim to be more of a strategic adviser in terms of the clients' investment strategy. In Brazil we work with most of the construction companies involved in the infrastructure sector. We also work with the concessionaires, the pension funds, and the infra-funds, both locally and internationally. We also try to build a link between the actual opportunities in the market with our clients' profile. This has been a longtime objective in the Brazilian market.

Do you help investors navigate the various government agencies that regulate infrastructure?

Our Government and Public Sector department, or GPS team, oversees local regulations. They also manage relationships with all the levels of governments. We count on them to assist us with our investment clients.


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