INSIDE THE MINDS

Corporate Law Client Strategies in Latin America

Leading Lawyers Discuss Best Practices for Leveraging Opportunities and Mitigating Risks in Latin America

ASPATORE

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An Overview of Latin American Investment Strategies and Structures

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Introduction

An Increase in Latin American Investment Opportunities

An increasing number of potential investors are seeking investment opportunities in Latin America. The reasons are varied. Some financial investors seek emerging market exposure or portfolio diversification or are attracted to the region's potential for long-term macroeconomic growth. Others invest for strategic reasons, and still others focus on valuation or currency dislocation. The types of investors interested in the region are also expanding from large institutional investors, development banks, pension funds, and companies with strategic interests to smaller institutional investors, family offices, and even high net worth individuals. The reality is an overall increase in investor interest and exposure to the region from a variety of investors, some experienced and some approaching the region for the first time. The goal of this chapter is to explore some of the principal investment strategies for investing in Latin America as well as some of the commonly used structures for deploying capital in the region.

Investment Strategies

The principal investment strategies for investing in Latin America are to invest through an investment fund, co-invest with another investment vehicle, or make a direct investment in the region through a merger or acquisition (M&A) transaction, joint venture, or other investment transaction. Each of these strategies has advantages and disadvantages.

Investment Funds

There are many kinds of investment funds. Blind pool funds typically aggregate capital for a series of as yet undetermined investments, while single investment funds are also formed for investing in specific bespoke companies or pools of assets. Funds also vary in terms of investment strategy—historically private equity funds invested in illiquid assets such as private companies, while hedge funds invested in securities and other more liquid instruments. The reality is that these lines have blurred in recent years, with hedge funds investing in illiquid strategies and private equity funds sometimes hedging. Still other funds invest exclusively in real estate,

infrastructure, energy, agribusiness, or another specific sector in the region. There has also been a rise of "alternative investment" funds, which can be considered a catchall for "funds investing in everything else." Because the strategic possibilities and structures are typically more complex for illiquid private equity investing in Latin America and they are a more realistic counterpoint to most direct investing and co-investing opportunities, most of the discussion on investment funds that follows focuses on blind pool private equity funds.

Private Equity Funds

Private equity funds are a common way to invest in Latin America. Most Latin American focused funds target mid-market opportunities and are sized accordingly, typically with commitments below $600 million. Many country-specific funds are even smaller. However, 2014 also saw the closure of several mega-funds targeting larger investments in the region, including what is thought to be the largest fund ever raised for Latin America, Advent Latin American Private Equity Fund VI at $2.1 billion. Most fundraising is for Brazil or regional funds, with a growing focus on Mexico.[1]

An investor in a private equity fund will be exposed to a broader array of investments and will normally have little to no active ongoing involvement in the investments—other than a possible seat on a limited partner advisory committee. An investor in a private equity fund will also typically have a defined exit horizon, normally ten to twelve years. There is a price for this diversification and delegation, however, in the form of bearing additional expenses, including organizational expenses of the fund, ongoing operational expenses and management fees, and the incentive drag that goes along with paying carried interest to the manager or its affiliates. It should be noted, however, that certain of these expenses are spread across multiple investments, which can be more efficient than paying separate expenses in respect of stand-alone deals, particularly when investing in smaller deals. Other than certain hedge-style funds, the withdrawal possibilities are typically also limited prior to the expiration of the term of the fund, given the illiquid nature of most private equity investments.

[1] *See* Latin American Private Equity and Venture Capital Association (LAVCA), LAVCA Mid-Year Data and Analysis: Update on Latin American Private Equity and Venture Capital (2014).

Co-Investing

There has been a surge of investor interest in co-investments in Latin America, including on the part of investors in blind pool funds. Co-investment opportunities are now an active topic of discussion with potential investors in Latin American funds at the fundraising stage. While historically fund managers might have offered co-investments to strategic partners and larger investors on an ad hoc basis, a broader spectrum of fund investors is now showing interest in (and sometimes demanding) access to co-investment opportunities. A recent study by Prequin found that 73 percent of fund investors had co-invested alongside a fund in the past, 40 percent were actively seeking new co-investment opportunities, and an additional 37 percent would opportunistically consider new co-investment opportunities.[2] The reasons fund investors seek such opportunities are many—often investors believe they will achieve additional exposure to a desirable sector, possibly at lower blended fees (in the case of reduced fee or no-fee co-investments). They may also be able to piggyback on the fund manager's due diligence and reporting. Meanwhile, the fund manager is able to complete larger investments without affecting fund diversification or tripping investment limitations. But the manager needs to exercise caution to define co-investment rules clearly, disclose them to investors, and implement policies and procedures to follow them so the allocation of investment opportunities does not cause compliance or operational problems or alienate investors who are not given access to co-investments.[3]

Co-investing typically involves investing with other investors—possibly with a blind pool fund—through a common vehicle or special-purpose vehicle that is generally structured as a pass-through entity disregarded for tax purposes. Such pass-through entities are also those typically used for blind pool funds when they invest without co-investors. Co-investing, therefore, has some of the characteristics of an investment fund (e.g., pooling of capital, sharing of certain expenses), but also some of the characteristics of direct investing (e.g., focus on one predetermined investment target). As mentioned above, sometimes co-investing is a complement to blind pool investing, for an investor to gain additional exposure to a particular investment beyond its indirect investment through an investment fund.

[2] Preqin Private Equity Spotlight, The State of Co-Investments (2014).
[3] *See* PwC, *Private Equity Co-Investment: Best Practices Emerging*, A Closer Look, Jan. 2015, at 1.

The advantages of co-investing as an investment strategy include more targeted investing than can be achieved through a blind pool fund that invests across multiple deals and the ability to more actively influence the target company through involvement on the board of directors or other oversight body and through the exercise of shareholder rights negotiated at the time of investment. Co-investing with local partners can help a foreign investor leverage local partner relationships and, when governed by a solid, well-balanced shareholder agreement, this strategy can be a win-win tactic for both foreign and local partners.

Co-investing may not be appropriate, however, for resource-constrained investors who have limited bandwidth to analyze new investments and decide to deploy capital quickly and then monitor their new investments once they have closed. Such investors may request access to co-investment opportunities but find they do not have the ability to react quickly enough to take advantage of such opportunities or the ability to manage them on an ongoing basis.

Direct Investing

Direct investing is attracting a broader range of investors, including experienced investors new to direct investing in the region. For example, in 2014 both KKR and Bain reportedly made their first direct investments in Latin America.[4]

Direct investing can be a compelling strategy for investors wanting a more active role in the target company. Direct investments are of course also appropriate for strategic investors with an interest in a particular target and no interest in diversification. In fact, direct investing is the most appropriate strategy for achieving an increase in global footprint for an investor that is an operating company. For example, the classic M&A deal is one common kind of direct investment.

The investor engaging in direct investing normally has a board of directors or similar involvement—with associated fiduciary duties to the local company—and actively oversees the target company. This may include the power to hire or fire management if the investor is a controlling shareholder. The

[4] *See* LAVCA, *supra* note 1.

disadvantage of this approach is potentially higher risk because of such involvement, including potential reputational risk in the event of problems at the portfolio company, such as violation of anti-corruption or environmental laws. Moreover, as previously referenced, there is little or no diversification with direct investing.

Mixed Investments

Not all investors choose to invest using only one of these strategies. For example, some institutional investors are investing through funds to "learn" a particular market in Latin America. They hope to add co-investments and direct investments in the region to their investment program once they understand the risk/reward profile better with a view to securing additional exposure in attractive sectors. In that regard, institutional investors investing in investment funds are routinely requesting specific co-investment rights in side letters at the time of investing in the funds, so as to increase their chances of being able to take advantage of attractive co-investment opportunities thereafter. In fact, if a fund investor is interested in co-investment opportunities, it is critical to discuss co-investment policies with the fund manager at the outset to ensure such opportunities will be available and allocated fairly. However, smaller institutions and family offices with fewer internal resources may determine that the additional oversight co-investments and direct investments require is too administratively burdensome as mentioned above.

Differences Between Investment Strategies

Chart One summarizes, for easy comparison, some of the differences between investing through an investment fund, co-investing, and direct investing, including with respect to certain additional secondary factors such as reporting and access to portfolio management.

Chart One: Summary Comparison of Methods for Aggregating Capital

	Fund	**Co-Investment**	**Direct Investment**
Diversification	High	Low	Low
Time Horizon	10 to 12 years	Variable	Variable

Active Management	Low	Medium	High
Additional Capital	No	Maybe	Maybe
Expenses	Additional expense at fund level	Some vehicle expense	Typically transaction expenses only
Incentive Drag	Yes	Maybe	Typically no
Non-Financial Risk Board/Fiduciary Duty/Reputation	Low	Variable	High
Early Withdrawal/ Liquidity	Typically no	Variable	Maybe, depending on transfer provisions
Reporting	Consolidated (metrics as agreed with GP)	Individual (can insist on GAAP or IFRS)	Individual (may be local standards)
Access	As negotiated (typically periodic)	Depends	Typically yes
"Wear and Tear"	Low (possible LPAC involvement)	Variable	High

Some of the comments in Chart One are generalizations. It should be noted that there are many varieties of each investment methodology, particularly when it comes to direct investment and bespoke investment (or co-investment) vehicles.

Latin American Investment Structures

Once an investor has determined the appropriate investment strategy or strategies for investing in Latin America, the next step is to settle on the best structure for such investment. Because the structures for funds, co-investments, and direct investments vary in many respects, we will discuss

them separately. For the purposes of the discussion of co-investment and direct investment structures, we assume a particular investment opportunity has already been identified.

Fund Structures

Investors planning to invest in funds focused on Latin America need to be knowledgeable about the various structures typically used for investing in the region, or at least about their own structural needs, so they can ensure the fund they are considering investing in has an appropriate structure in terms of cost, tax efficiency, and flexibility over the expected time horizon of the fund.

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 American fund needs to factor in tax considerations, reporting requirements, investors targeted in fundraising, and target 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 US advisors is to start with Delaware as a jurisdiction for a new fund. This can be an attractive jurisdiction for funds investing in Brazil, but many European investors fear that a change in law might somehow submit them to US taxation, among other reasons. Investors requiring a non-US vehicle may also insist on an offshore fund, in which case a single non-US fund may be preferable administratively to a Delaware fund plus an offshore parallel fund. Non-US advisors may also avoid the United States when it leads to additional regulatory requirements.

Although familiar for European investors, many European jurisdictions such as Luxembourg can be cumbersome and expensive, and involve time differences and additional registration requirements leading them to be used infrequently for Latin-focused funds with illiquid strategies. Luxembourg and Ireland do, however, have tax treaty networks that may make them appropriate choices for more liquid strategies.

The Cayman Islands is a typical jurisdiction for forming funds for investment into Latin America, particularly for liquid investment strategies. However, it now appears on certain countries' "blacklists," with the result,

for example, that if a Cayman fund invests directly in Brazil, there will be substantial tax withholding. This has led funds to either adopt elaborate "below the fund" structuring when focusing on investing in such countries or to seek other options. Certain investors also may prefer to invest through another jurisdiction if they perceive that investing through the Cayman Islands will submit them to additional audit risk in their home countries.

Canada has been growing in popularity as a good jurisdiction for forming funds investing in Latin America, particularly funds targeting Mexico, due to a favorable tax treaty with that country. A high percentage of the new broad-based private equity funds for Latin America formed in the last year or so chose Canada as their jurisdiction of formation. Managers should note, however, that certain offshore fund advisors forming Canadian investment funds may need to register as Canadian investment advisors, particularly if their investment strategy is not a pure private equity buyout strategy.

"Local" fund structures—formed in the principal country in which funds will be invested—are also increasingly common. Recent legal reforms have allowed pension funds in certain countries such as Brazil, Chile, Colombia, and Mexico 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 opportunities to invest in solid funds managed by reputable fund managers. 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" (FIP) that 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 percent of an FIP has a 0 percent withholding tax.

Fund managers targeting Colombian pension funds are also forming "Fondos de Capital Privado" (FCPs) to attract the investment of such pension funds as core investors. Mexican pension funds are now able to invest in private equity,

but with few exceptions, they can do so only through a heavily regulated structure involving the issuance of "Certificados de Capital de Desarollo" (CKDs) traded on the Mexican Stock Exchange. This structure has had mixed results in attracting new managers to form Mexican domiciled funds.

The prospective investor may find itself presented with a fund formed in any of the aforementioned jurisdictions, or others. In addition to confirming whether the fund is efficiently structured as a general matter, it must confirm whether any special tax or other needs—such as opt-out requirements mandated by internal policy—have been adequately addressed in the structure. Most fund managers leave open the possibility of parallel funds to give themselves structural flexibility in the event their main fund vehicle cannot accommodate a particular investor or type of investors. However, such managers may be reluctant to form additional vehicles unless the investment amount is large enough to justify the additional expense and administrative burden associated with such vehicles.

Co-Investment Structures

As noted above, investors are increasingly seeking co-investment opportunities with investment funds and other investors. They may want additional exposure to a particular transaction to which they already have exposure through a blind pool fund. Alternatively, based on their presence in the market, investors may be invited to co-invest with other financial or strategic investors in a consortium where a transaction is too large for such investors given their diversification criteria or investment limitations.

Typically investors will aggregate capital in a vehicle structured as a pass-through for tax purposes. The shareholders' agreement of this vehicle will be an important document that lays out each party's rights and obligations with respect to economics, governance, reporting, transfer of shares, and the like, as well as whether there is an obligation to contribute additional capital. Depending on the jurisdiction in which the vehicle is formed, it may be important to reflect many of these provisions in the charter of the vehicle itself, because in some countries such as the Cayman Islands, the charter prevails over a shareholder's agreement in case of conflict.

Because a flexible vehicle is typically chosen for aggregating capital for co-investments, the parties have a range of options—from a simple vehicle to a

highly customized one—they can consider in designing the vehicle. A blind pool fund forming a co-investment vehicle for existing investors to invest in will likely want to keep such a vehicle simple and keep most control rights with the main fund. A co-investor investing purely to have greater exposure to an investment with a lower blended management fee and carry drag may be perfectly fine with such an approach. However, wide variations can occur, particularly when the co-investor is "new" to the other vehicles investing or needs specific protections regarding voting or exit rights, for example.

Transfer provisions can be particularly important when investors co-investing together have different time horizons for an exit or when shareholders' agreement terms are dependent on specific preexisting relationships and are expected to change if a new investor joins the investor group in the future. It can be important to specify which rights "follow" the shares in the entity and which are personal to the individual investors.

It is also important to consider whether, and to what extent, local law governs the vehicle, because local law may govern regardless of the contractual intent of the parties in some cases. The co-investment agreements must also provide for adequate dispute resolution procedures. Enforcement in most Latin American jurisdictions can be extremely slow in the courts. For example, in its "Doing Business 2015" report, the World Bank ranked Colombia and Peru the highest overall of Latin American countries based on the "Ease of Doing Business" (ranked 34 and 35 respectively out of 189 countries worldwide); yet these countries rank much lower on the metric of "Enforcing Contracts" (ranked 168 and 100 respectively).[5] For this reason, parties to co-investment and related contracts normally provide for arbitration and try to structure agreements to minimize the chances of needing to rely on dispute resolution provisions in the first place.

Sometimes co-investment will occur between multiple pooled vehicles. The same challenges will apply as in the case of co-investment between a pooled vehicle and a non-pooled entity unless the pooled vehicles were specifically formed to invest together, as in the case of parallel funds. In some markets, master-feeder structures are not common and parallel funds must enter into

[5] *See* World Bank, Doing Business 2015: Going Beyond Efficiency, *available at* www.doingbusiness.org/reports/global-reports/doing-business-2015; and the rankings: *Economy Rankings*, World Bank, www.doingbusiness.org/rankings.

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.

Direct Investment Structures

As investors become more comfortable with investing in Latin America through pooled vehicles, more of them are "going direct," either by co-investing as previously described or simply finding direct investment opportunities themselves as noted above. Direct investing is also the typical approach of strategic investors.

Direct investing is easier in some countries than others. For example, Colombia has few barriers to direct investment and few foreign ownership restrictions. On the other hand, countries such as Brazil have limits on rural land ownership that may restrict or complicate agribusiness deals and certain other transactions. Some countries have also at various times limited capital inflows or outflows using mechanisms such as capital registration requirements and taxes. For example, Brazil's IOF tax can be raised or lowered by executive decree within certain limits to achieve public policy goals such as combating currency speculation.

Direct investors that are not strategic players in the relevant market niche of the investee company may not have the know-how or administrative bandwidth to monitor or transform an operating company to the extent a fund manager with a local team can, but often such investors will tag along with other like-minded investors and/or local players who may have the ability to be more proactive. Such "consortium" direct investing can end up looking a lot like co-investing because the investors need to negotiate their relative rights vis à vis the investee company in addition to making the direct investment.

Despite being called "direct," most direct investing involves investing through some sort of special-purpose vehicle for tax efficiency, but shareholder arrangements may be implemented at the local operating level without another layer of governance. This may complicate the negotiation of such arrangements, as it is more likely to involve management and other local stakeholders who have additional relationships with the investee company.

Direct investment may take the form of a classic M&A transaction in which an entire company changes control; but it may also take the form of a joint venture or investment in a majority or minority stake of a local company. A high percentage of businesses in Latin America are family owned, and this can make it more difficult to invest in a control stake or complete an outright acquisition.

Minority investing raises its own challenges, however, including negotiating appropriate shareholder provisions as referenced in the previous co-investment discussion. Such negotiations are typically more complex if negotiated directly at the target level. Diligence can also be more complex, as there are often many related party transactions, particularly if the business invested in is only a portion of a larger family conglomerate, in which case the investor needs to carefully scrutinize the various services and agreements with other related entities.

In direct investing, the investor typically needs to take on the burden of understanding and meeting regulatory requirements, including antitrust filings, and may be involved in obtaining currency hedges or local working capital, all of which in a pooled vehicle would ordinarily be taken care of by the fund manager.

Conclusion

There is no one-size-fits-all investment strategy or structure for investing in Latin America. The main purpose of this chapter has been to compare various investment strategies and explore certain common structures and relevant considerations to better educate potential investors and their advisors about their options with respect to strategies and structures for achieving investment success in the region.

We predict that funds formed to invest in Latin America will continue to proliferate as investors seek access to the region without a heavy administrative or monitoring burden. But we also expect that investors in such funds will continue to seek additional complementary investment opportunities in the form of co-investments and direct investments in the region to increase their exposure to specific countries, industries, and sectors of interest.

While investment fund and deal terms will generally remain private (Mexican CKDs and other structures aside), we believe the structures and general terms for similar products will continue to converge as managers raise second and third (and beyond) generation funds for the region, investors continue to make investments through and with such funds, and foreign investments in the region proliferate. This should also lead eventually to more secondary market transactions in interests in such investment funds, as well as new financing, hedging, and insurance products for such funds. While the countries and sectors of interest will no doubt fluctuate over time, we believe demand for investment products providing access to the region will continue to grow and investors will have an ever-increasing need for reliable information about effective investment strategies and structures.

Key Takeaways

- Investors should carefully determine which investment strategy or combination of strategies is best for them to achieve exposure to investment opportunities in Latin America, taking into account their need for diversification, capability to actively manage investments, and other key factors.
- Investors new to the region should consider achieving exposure to the region through an investment fund unless they are strategic investors pursuing direct investment opportunities.
- Fund investors should discuss co-investment policies and potential opportunities up front with the fund manager at the time of investment to maximize access to such opportunities and ensure they are allocated fairly.
- Once the optimal strategy or strategies have been identified, investors should pay particular attention to structuring the investment (or diligencing the structure) to ensure it is appropriate and efficient for the target countries and meets their own structural needs.

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