LATAM my love

A new approach for Private Equity firms when investing in Latin America

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As a new year begins, a very peculiar phenomenon can be observed in the LATAM Private Equity industry. There have been 2,455 deals as of Q3 2022, which account for 86% of the total number of transactions that occurred during 2021. Moreover, the deals year-to-date represent an increase of 6% and 5% of the total number of transactions that occurred during 2017 and 2018, respectively.

This reveals that we are undergoing a successful post-covid period for the industry. But it's not enough to look at historical data, we also need to divert our attention towards forward looking relevant fundamentals. With those, we stop and reflect on the key parameters that make the difference in successful transactions.[1]

Chasing a worthwhile investment opportunity often means going beyond a country's borders and looking into high growth regions such as Latin America. The vibrant markets, younger population and a wealth of natural resources, paired with attractive incentives, make it an obvious choice when looking for an investment target.

However, there are certain aspects that are often overlooked in the Latin American region since they may not play such a vital role in other markets. Due to cultural and economic factors, the markets in this region are highly pulverized- meaning there are millions of small consumers like mom & pop's (*changarritos*), owner-operator logistic companies in truck drivers (*hombre camión*), small mechanic shops (*talleres*), small hardware around the corner shops (*ferreterías*), and many more that are often difficult to reach directly.

Particularly in Mexico, there are around 987 thousand *changarritos*, 155 thousand *hombres camión*, 243 thousand *talleres*, and 64 thousand *ferreterías*. In total, they represent around 20% of the total number of businesses in Mexico.

In LATAM 99% of companies are MSME's (micro, small and medium-sized companies).[2] These MSMEs still have a long way to go in terms of financial inclusion. As of today, less than 40% of the MSME's in Mexico accept payments with credit cards.[3] Furthermore, in terms of distribution, third-party distributors often brid the gap between large companies and consumers, in order to reduce cost to serve to a price that will remain profitable for both the producer and the distributor. These distributors, thus, play a vital role as enablers or blockers of growth.

1. TTR
2. Directorio Estadístico de Unidades Económicas
3. T21

So...

Researching an investment opportunity in LATAM means looking beyond the target, and into distributors, suppliers and the country's particular situation. We found an extra set of aspects for LATAM targets and find it imperative to study them with care and detail before making an investment decision.

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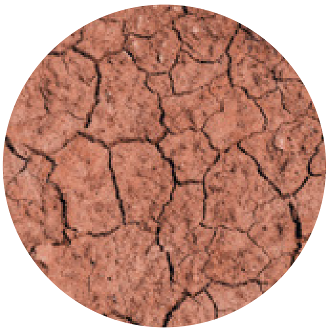

A. Power, configuration and fragmentation of the distribution channel

Many distributors have long-standing agreements with companies that may or may not be recorded in-writing nor even on a formal contract. Some of these (formal or informal) agreements include terms of service, pricing arrangements, or sponsorship arrangements that have been maintained for years due to a historical relationship with the target company and may mistakenly be taken for granted.

There could be an important dependency on the distributor and even old business practices that could become hard to break, or, at best would represent time spent or an extra cost that could be overlooked during the due diligence process.

B. Culture beyond the target

Where suppliers and distributor behaviors are involved, a PE firm may thoroughly understand the target's culture and the end-consumer's behavior, but it is also important to understand the supplier's and distributor's culture to get the full picture. There are three important aspects regarding culture that must be evaluated:

1. Willingness to go digital

In today's market, a way to create competitive advantage is by using digital strategies (technology, advanced analytics, machine learning, AI, etc.) Often, a company depends on suppliers and distributors to join into the digital strategy to make it work. For example, in the logistics industry, one crucial differentiator is tracking units via GPS and letting the end-customer know where their products are at all times. In the fragmented logistics industry in Latin America this is often a barrier. Some small logistical companies may resist using these technologies because of the costs of GPS or the need to use the operator's mobile phone as a tracker, and some just because they don't want to be tracked at all. This may well create a barrier to growth for the PE target that may hinder or block the expected results of the operation.

Another example on the supplier side could be reluctancy to transact over a well-established sourcing platform, where information about prices and volumes must be made public (or not), or simply because uploading documentation and data in a structured way is not part of their capabilities, yet you depend on them for a specific raw material or component that are key to your manufacturing process.

Latin America still has a long way to go in digital penetration. Estimating by tech market cap as a percentage of GDP, the region is at 2.2%. This puts it 10 years behind China, with 27%, and 15 years behind the United States, which has 39% penetration. However, the region has been making up for lost time, with an estimated growth of 65% in tech penetration compared to China's 40% and the US's 11%.[4]

4. Economic Commission for Latin America and the Caribbean

2. Level of institutionalization

In general, LATAM is polarized between high-productivity, multinational companies, and small, frequently informal companies, while it lacks medium-sized companies. Furthermore, there are fewer large and medium-sized firms (over US $50 million in annual revenue) in LATAM countries on average than in Turkey, India, South Africa, and many Asian emerging-market economies. As a result, there are many distributors who have robust business processes, ERP's and even online services, but there are other much less mature companies who often rely on more modest or outdated processes. In analyzing a target, the PE firm must factor in the cost of institutionalizing the distributor or supplier to take full advantage of advancing the target's potential for a robust business model and streamlined processes.

This could go from basic administrative processes that could run better on a given technological tool, to trying to implement bar coding tools for inventory purposes or the use of handheld devices by their sales forces, all these examples could take long time and cost for the distributor to implement.

3. Degree of generational independence and alignment

Distributors are often family businesses where there are several generations involved. This can create a misalignment in inside interests. Newer generations may not be too interested in the business and often have started other ventures, while older generations already have a good standard of living and are eager to retire. It is estimated that only one out of three family businesses are passed on to the next generation successfully in LATAM. This may lead to less interest in conquering new consumers or markets. The opposite may also be true. In the end, these differences in interests may result in a business that is not performing at the level necessary to continue growth.

C. Potential difficulty for vertical integration

How hard it is going to be to implement a direct sales channel or e-commerce. Considering the challenges that distributors may pose, investors may decide to skip the middleman. This in turn must be factored into the profitability equation considering the level of difficulty in reaching customers directly (road connectivity, concentration of population, etc.) and the level of internet connectivity in the country or region that is being targeted. In this sense, in terms of percentage of the population using the internet, Latin America is at 74%, while China and the US are at 70% and 91% percent, respectively, according to the World Bank. Furthermore, in terms of road quality, the World Economic Forum estimates that the LATAM countries with the highest road quality are the Dominican Republic and Mexico. However, they are only ranked in 43rd and 47th place, respectively. Due to the difficulties presented above, a more thorough analysis should be conducted by a firm thinking of skipping the middleman to enter LATAM markets.

D. Nearshoring

During the past decade, the US has gone from pushing forward international trade agreements to imposing tariffs on specific goods and implementing restrictions on national security grounds. This has forced companies to reassess their supply chains across the companies' operations. Setting up nearshoring operations in Latin American countries such as Mexico is incredibly attractive for companies that try to reach the U.S. market, due to the region's location, similar time zones and easy access.

For PE firms, companies that have access to nearshoring opportunities could become an attractive target. Since nearshoring could save time and economic resources, as well as making a company more efficient, it should have a direct impact in costs, therefore helping companies have a better financial performance.

E. ESG considerations

According to EY's own research, 30% of consumers in LATAM make their purchase decisions based on their environmentally friendly characteristics. Yet less than 30% of companies within the region have a clear ESG strategy; This is huge for PE firms, knowing that both the regulatory and market outlook for the next years is to really make companies comply with ESG fundamentals. It is imperative to include a thorough diagnosis of the target's ESG competencies and capabilities in the due diligence process.

F. Local (almost native) knowledge

PE firms are often experts in certain sectors, industries or even regions, but in Latin America things can show variations even at the city or street level. Having a "boots on the ground", local expert must be part of the due diligence team in order to identify these particularities. Changes in traffic, local political environment, neighborhood mix etc. can often make or break a successful deal. For example, there was once a large piece of land next to a lake that was sold to a company for development, but it turned out that the local mayor was in a rift with one of the neighboring plot owners and was blocking the initiative to build a road to the area, citing environmental concerns and lack of municipal budget as an excuse. Only a local expert could have been aware of small town's rumor mill.

Furthermore, according to TMF Group's Global Business Complexity Index Ranking, LATAM's 5 largest countries are located inside the top 12 places where conducting business is the most challenging for international firms due to regulatory and compliance factors.

While it may already be a widespread practice, in LATAM it is important to consider the political risks inherent to the region. Radical shifts in power, dwindling reserves, protests, and populism, to name a few, continue to present challenges for foreign investors in LATAM attempting to track and predict growth trends, and protect their investments.

In the end, investing in Latin America is a good opportunity, if it is carefully considered and meticulously researched. It is important, in order to mitigate the risks of a transaction, accelerate value realization of the strategic acquisition and beat the competition, to have the support of someone with local knowledge who understands the business culture of the country of operations. PE firms with ample knowledge or presence in the area will do well in looking beyond the target and into suppliers and distributors before making a final decision. Indeed, the targets in Latin America are very different, with more aspects to examine. This may be the difference between success and failure.

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