Argentina Sees Revival of Private Equity Players

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After Argentina's economic upheavals and last year's fall from grace, private equity funds are venturing back, sniffing out potential deals and picking up cheap assets where they can. This year nearly a dozen deals have closed, with players including multinationals such as Citibank and HSBC Private Equity Latin America, plus a hybrid of other funds led by Argentine and foreign investors.

That Argentina is seeing nascent activity in private equity 18 months after the country's sordid devaluation and political meltdown is no mean feat, observers say. "Last year no one knew if Argentina would be functional or not," says Fernando Munoz de Toro, a Buenos Aires attorney who advises private equity firms. "There was too much uncertainty for investors – fears of looting, fears of uncontrollable inflation, and borderline chaos."

Fears indeed. Argentina defaulted on foreign debts of $140 billion. Stuck in a four-year recession, joblessness topped 22 percent. In less than a month, Argentina saw five presidents come and go. After almost a decade, the peso became unglued to the dollar and tumbled nearly 75 percent. The economy shrank 11 percent in 2002 and companies with dollar debts but peso-denominated revenues lost billions.

Some of the unnerved fled. Verizon Communications ditched its Argentine cellular phone operator CTI Movil after the local company defaulted on mostly dollar-denominated loans of $1 billion. (A group of strategic investors and private equity firms recently bought the firm for an estimated $220 million). For the many companies and foreign-owned subsidiaries in arrears, "it was cheaper to walk away from your investments and take a tax write-off" than lose tax benefits, Munoz de Toro says.

Many signals suggest that Argentina's latest crisis has, for now, petered out. Quarter on quarter, industrial production is rising. Exports have surged. After last year's lows of 4 pesos to the dollar, the peso has since rallied. Inflation and interest rates stabilized, and Argentina's economy this year is expected to grow 5 percent.

That's not to say that today Argentina is a turn-around story, says Wharton management professor Gerald McDermott. "They have still got a long way to go. They have lost 20 percent of their economy in the last four years. Anything you see now is window-dressing."

Still, there's tremendous upside, McDermott suggests. "They have an educated workforce and good infrastructure. It's a fairly sophisticated place." Sectors poised to attract buzz are biotech, pharmaceuticals and agricultural-related firms.

Headline deals include Southern Cross Corp., which agreed to inject about $140 million of fresh capital into natural gas company Compania General de Combustible. (In a new wrinkle, however, CGC bondholders are contesting the deal.) Southern Cross Corp. later bought U.S.-based Dial Corp's Argentina assets after Dial opted to exit Argentina.

An Excess of Exuberance

Argentina saw an unbridled burst of private equity commotion in the 1990s. The poster boy nonpareil of Argentina's go-go period was Exxel Group's Juan Navarro whose leveraged buy-out firm invested in nearly 65 companies. Most deals, however, would later prove to be half-baked and overzealous – and shaped by rosy assumptions about the fundamentals of Argentina's economy. Aggressive investors later suffered losses when growth slowed and the nation sunk into recession starting in 1998. "They fell into a perfect storm," says Wharton finance professor Andrew Metrick, who teaches an Exxel case study.

Investors lost on almost all deals, says Buenos Aires-based Mario Quintana, managing director of Pegasus Capital, a Boston private equity firm. "There was an excess of exuberance. The leverage was high and the prices were high. Pegasus, which has cash reserves of $300 million for prospective Argentina deals, will be eyeing more local deals this year.

"The last few years have been very disappointing and distressing," adds Stephen M. Sammut, a senior fellow and lecturer with Wharton's management department. "Private equity can be very powerful as a development tool, but private equity professionals have to develop managerial approaches unique to that region." That means on-the-ground management attention: If investors acquire a turn-around company in a far-flung province in Brazil, yet operate their private equity firm from Rio de Janeiro, "that would be like trying to serve Chicago or St. Louis from Boston," Sammut says.

Deals sealed in the 1990s had little time to blossom under the stewardship of private equity firms. "Only a few investors had time enough to enter, create value, then leave," says Patricio Rotman, a finance professor at Universidad de Palermo and an M&A consultant. Of the dozens of deals closed, Rotman estimates no more than 10 deals yielded investors a 30 percent return, and no more than 20 deals matured under auspices of private equity firms.

A key difference between deals sealed in the high-flying 1990s and today is debt-to-equity ratios among the distressed. "In the 1990s, value was expected to come from growth and leverage. Today, value comes from debt restructuring and turnarounds," Quintana says. "Many companies are no longer viable because of their capital structure."

Quintana's Pegasus recently acquired 100 percent of Musimundo, a music store chain once controlled by Exxel. Pegasus negotiated the buy with a group of banks which gained control of Musimundo after the company defaulted in 2001 on loans of $200 million.

Optimistic that purchasing power will heal, Pegasus is attracted to plays in retail and entertainment sectors, and anticipates an investment horizon of five years. The firm looks for internal rates of return of 35-40 percent.

Paradoxically, Quintana says, companies with attractive assets and sound management are today among the most battered. That's because pre-devaluation, the fittest secured dollar loans abroad, snubbing loans at home where interest rates were higher. "They have the worst balance sheets, but in many cases the management was good. It then becomes a matter of debt restructuring."

But the pile of distressed companies also includes those with unsavory pasts. Pegasus is just one in a line of strategic and private equity players vying for Dutch-owned Ahold's Argentine supermarket chain Disco. Scandal-tarred Ahold last year paid $490 million to acquire a 100 percent in Disco, up from 66 percent (as with Ahold-owned supermarkets in the U.S. and Holland, Disco also faced mismanagement issues.). Current valuations estimate Disco's worth at around $300 million, reports say.

The Hunt for Assets

Rotman says private equity players today are more grounded. "The style will be more conservative. Opportunities will come from a clear vision of what assets you're buying and how to turn them around," he says. Deals are expected to be smaller than those closed in the flush 1990s. Munoz de Toro expects investment windows of four to six years - "maybe fewer."

According to Metrick, until exit strategies become more evident, many private equity investors will stay clear. "There's not a great path to profitability. That's the main constraint in all emerging markets and it's particularly evident in Argentina," he says.

Mexican strategic investors – longtime veterans themselves of currency debacles and debt crises – are stepping into the hunt for Argentine assets at fire-sale prices.

Mexican-owned America Movil is one of various companies that acquired a piece of CTI Movil. Mexican bread maker Grupo Bimbo SA is taking a 30 percent stake in bankrupt Compania de Alimentos Fargo SA. Bimbo is angling for full ownership of Fargo, pending an okay from Argentina's anti-monopoly officials. Mexican-owned Grupo Posadas, which operates in Argentina, will likely acquire more tourist-oriented businesses.

Investors from Chile and Brazil are expected to step up investments in Argentina. Chilean firms have bought agricultural real estate and are investing in Argentina's wine industry. Last year Brazilian companies invested $1 billion acquiring oil and natural gas and beverage assets, and a Brazilian telecom this year bought a 20 percent stake in broadband company MetroRed.

Regulated sectors such as public utilities are seen as riskier plays because tariffs are highly political, Quintana says. Dominant telecom investors Telefonica de Espana and French-owned Telecom have beseeched President Nestor Kirchner to raise phone rates, which have gone unchanged since the peso devaluation. Kirchner, who has taken a tough stance against the IMF in debt talks, has stonewalled, saying Argentines cannot pay higher utility bills.

Changes in bankruptcy laws are expected to stimulate new private equity deals, Rotman says. "Before, there was no middle ground between companies and creditors. There was either an agreement between the two – or the company went bankrupt" and sold its assets, he says.

These reforms, many of which passed in 1995 but haven't been tested until now, will create what Rotman calls the "cram down criollo" in which local judges can force shareholders of an indebted company to transfer ownership of stakes or shares to a third party. "This avoids a liquidation of company assets," Rotman says. Argentina's Congress this year passed a law offering immunity to "cultural industries" – mainly media companies – from the "cram down" clause, but Rotman expects many private equity firms to acquire companies.

Earlier this year creditors were taking haircuts as deep as 80 percent on the principal of some corporate loans. "But that's not happening anymore," Rotman says. "Creditors figured out that they could get more for their assets than they were getting."

In these times, a meticulous due diligence is paramount, states Munoz de Toro. "You don't want a company with hidden debt or contractual obligations. You think it has zero liabilities, then you find a $1 million outstanding loan and suddenly your company is worth $1 million less." Once creditors learn that a distressed company is courting private equity firms, they will quickly circle round.

Have previously-imperious investors learned lessons? "They are a lot humbler," says McDermott.

Once compared to buy-out king Henry R. Kravis, Exxel's Navarro was recently quoted in local magazine Apertura saying that he's maintaining a "wait and see" posture on Argentina before leaping back into the M&A fray.

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