The 2013 Meeting of the Latin American Corporate Governance Roundtable

Session 1: Trends and Factors Impacting on Equity Market Growth in the Region

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What has changed in Latin American Equity Markets in the past 15 years? (1/2)

Topic	Late 90's (97-99)	2013 (latest data)	Progress (1-4)
Market capitalization of listed companies	Low *(28% of GDP)*	Intermediate *(50% of GDP)*	4 *Colombia as best in class (15% to 60%)*
Total value of shares traded	Very low *(11% of GDP)*	Low *(22% of GDP)*	3 *Brazil as best in class (15% to 40%)*
Number of listed companies	Very low *(4.1 listed companies per million inhabitants)*	Very low *(2.5 listed companies per million inhabitants)*	1 *No best in class*

4 Substantial progress
3 Some progress
2 Lack of progress
1 Deterioration

What has changed in Latin American Equity Markets in the past 15 years? (2/2)

Topic	Late 90's (97-99)	2013 (latest data)	Progress (1-4)
Market concentration	**Very high** *(Share in total market cap of top 10 most cap firms: 55%)*	**Very high** *(Share in total market cap of top 10 most cap firms: 64%)*	1 *No best in class*
Free float level	**Low** *(25% of all outstanding shares)*	**Low** *(23% of all outstanding shares)*	1 *No best in class*
Ownership concentration	**Very high** *(72% of all shares held by the 5 largest shareholders)*	**Very high** *(76% of all shares held by the 5 largest shareholders)*	1 *No best in class*
Companies with dispersed ownership	**Virtually Nonexistent**	**Rare but existing** *(9% of companies with 5 largest shareholders holding <50% of voting shares)*	3 *Brazil as best in class (0% to around 7%)*

1 Deterioration
2 Lack of progress
3 Some progress
4 Substantial progress

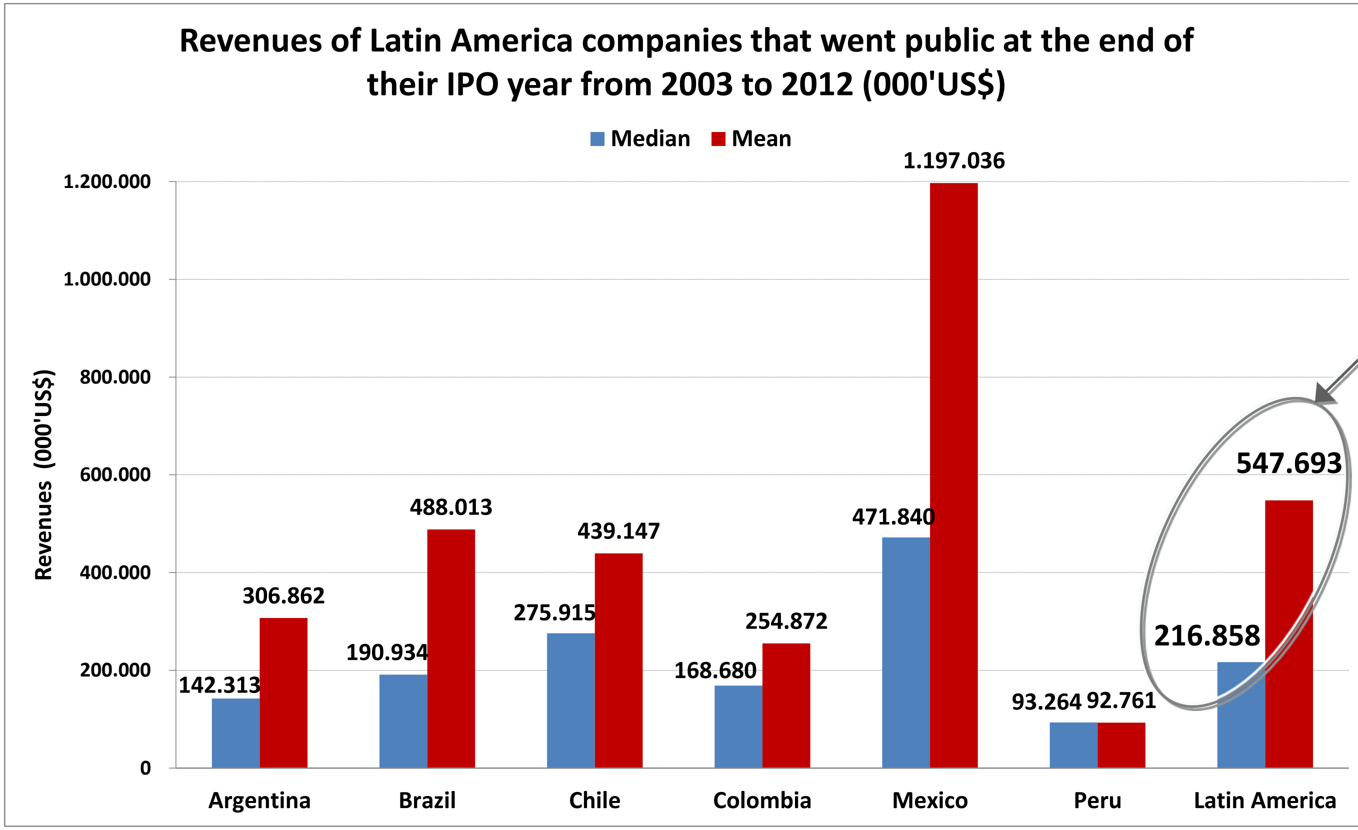
IPOs in Latin America: number of deals in the past 10 years

61% (155 out of 256) of the offers during the 2004-2007 IPO wave – possible reasons:

1. Easy credit conditions and asset bubble worldwide
2. Macroeconomic stability in Latin America (coupled with commodities boom)
3. Companies (fuelled by investment banks) making use of a "window of opportunity" resulting from hot/mispriced markets
4. Improved investor protection at the country-level (through regulation or self-regulation such as Novo Mercado)
5. Improved corporate governance practices at the firm-level

Items 4 and 5 deal with structural changes – to what extent they have been the cause of an increase of IPO activity in the region?

IPOs in Latin America: size of companies that decided to go public



Median revenues (US$) of companies that went public	
Latin America	U.S. (2010-2012)
217 MM	95 MM

Share of small firms* among companies that went public	
Latin America	U.S. (2003-2009)
17%	44%

Sources for U.S. data:
Where have all the IPOs gone? Gao, X., Ritter, J., Zhu, Z. 2012. Available at http://ssrn.com/abstract=1954788
The JOBS Act: One-year anniversary An overview of implementation after one year and an analysis of emerging growth company trends. Ernst & Young. 2013.
* Small companies are defined as those with revenues below USD 50 million.

The Brazilian Case

1. **Accounting for 56% of all IPOs in the region (143 out of 256)**

2. **Around 3/4 taking place in the 2004-2007 IPO wave (106 out of 143)**

3. **Around 1/3 involving companies from the real estate and financial services industries (47 out of 143)**

4. **52% of all capital raised went to the 20 largest IPOs, 15 of them non-independent companies (carve-outs, demutualization, etc.)**

5. **Only 0.5% of medium and large companies are currently listed on the stock exchange (400 firms out of 66,000*)**

*Source: IBGE (Brazilian Institute of Geography and Statistics) statistics from the Business Demography 2010, available at ftp://ftp.ibge.gov.br/Demografia_das_Empresas/2010/demoemp2010.pdf

Why companies are not using primary equity markets as an engine for growth in Brazil? The supply-side of equity

1. There is an alternative (cheaper and less stringent) source of finance: the BNDES

2. Controlling owners may fear losing absolute discretion over all decisions as well as suffer excessive pressure from a market that is increasingly viewed as focused on the short-term

3. The increased transparency required from listed firms could affect a sort of "competitive advantage" in delicate subjects such as:

   - Tax (reduced scope for tax evasion)

   - Political donations (especially for those depending on government bids)

Aside the macroeconomic issues, why demand for equity is not as high as before 2008 in Brazil? The demand-side for equity

1. State interventionism at the industry-level (Electricity, Financial Services, etc.) as well as at the company-level (Petrobras, Vale, Banco do Brasil, Oi, etc.)

2. Corporate governance problems with listed companies:

   - Frauds (Agrenco, Banco Panamericano, Banco Cruzeiro do Sul)
   - Huge derivative losses due to improper risk management (Sadia, Aracruz)
   - Controversial restructurings involving Novo Mercado firms (Cosan, Tenda)
   - Dismal performance of high-profile companies (“X” Group, HRT, etc.)

3. Evidence that some companies are more interested in corporate governance as a marketing tool than as a new approach for the business:

   - Partial failure of Novo Mercado reform, 1/4 still refusing to disclose compensation as required by the CVM 2009 regulation, etc.

What can be done? Next steps to facilitate capital formation through primary equity markets in Latin America

1. Increase the transparency requirements of medium and large privately-held firms in order to reduce their "competitive advantage" – raise the standards

2. Stock exchanges should foster a market structure that helps SMEs, favoring a "long term investor model" rather than replicating the "trading model" currently prevailing in developed markets (based on HFT, decimalization, etc.)

3. Continuous acculturation programs for privately-held firms are essential. Entrepreneurs should be convinced that good governance is valuable for their business, rather than mere formalisms required from third parties:

   - Effective corporate governance enhance competitiveness by improving top level decision making and reducing the chance of negative surprises

   - This creates long term value for their companies and society

END

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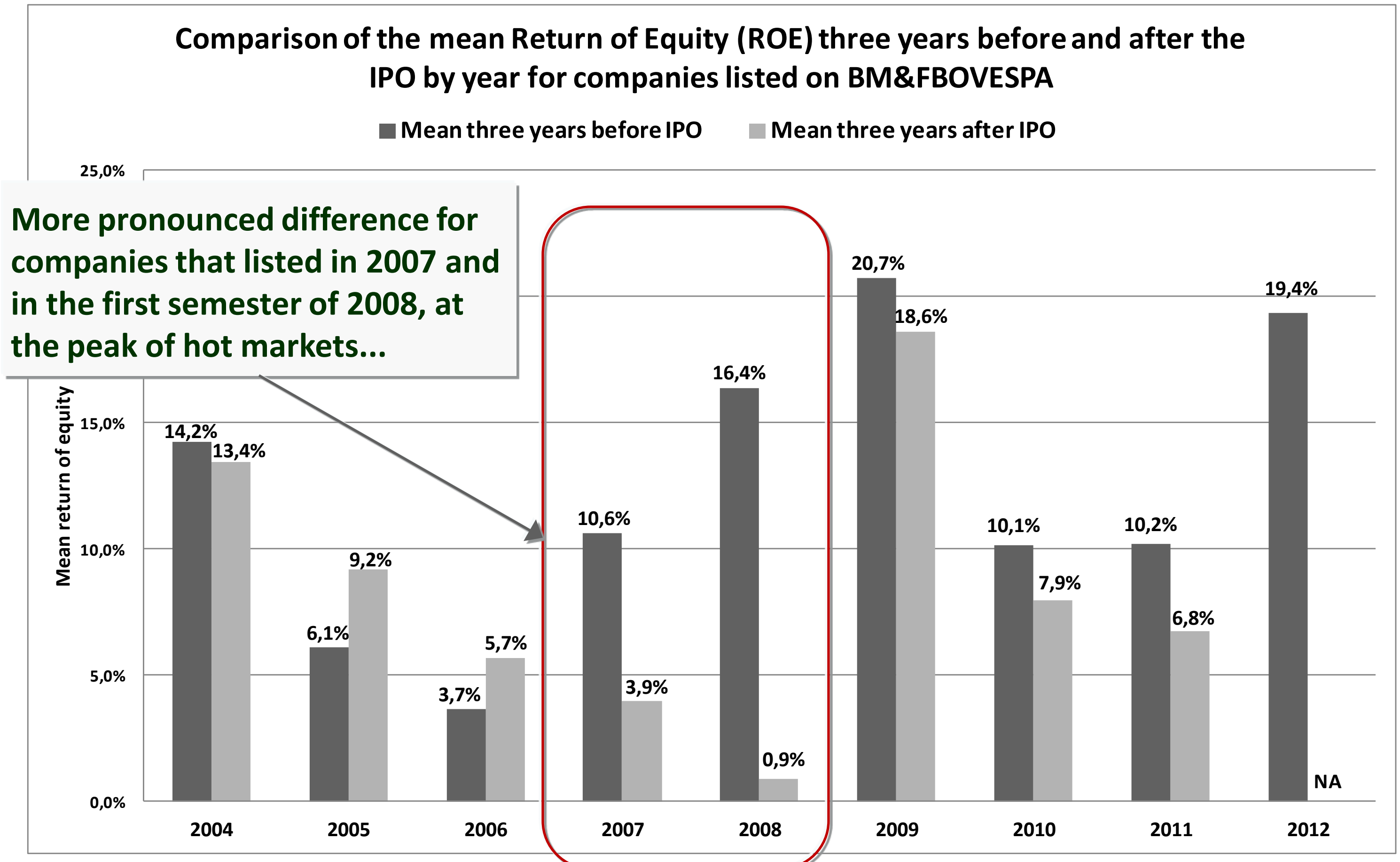
IPOs in Latin America: overview of the past 10 years
Profitability of companies that launched their IPOs in Brazil – ROE



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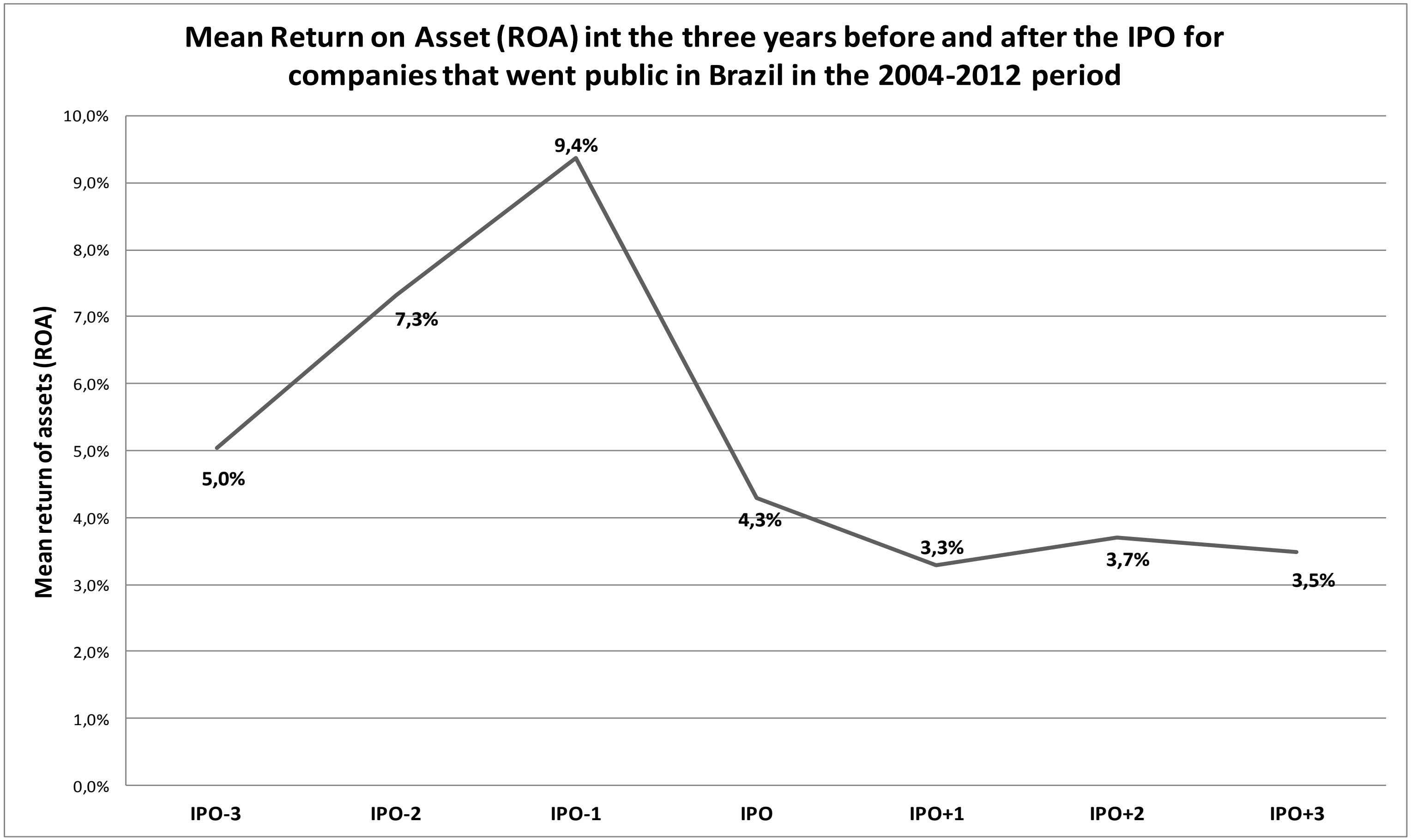

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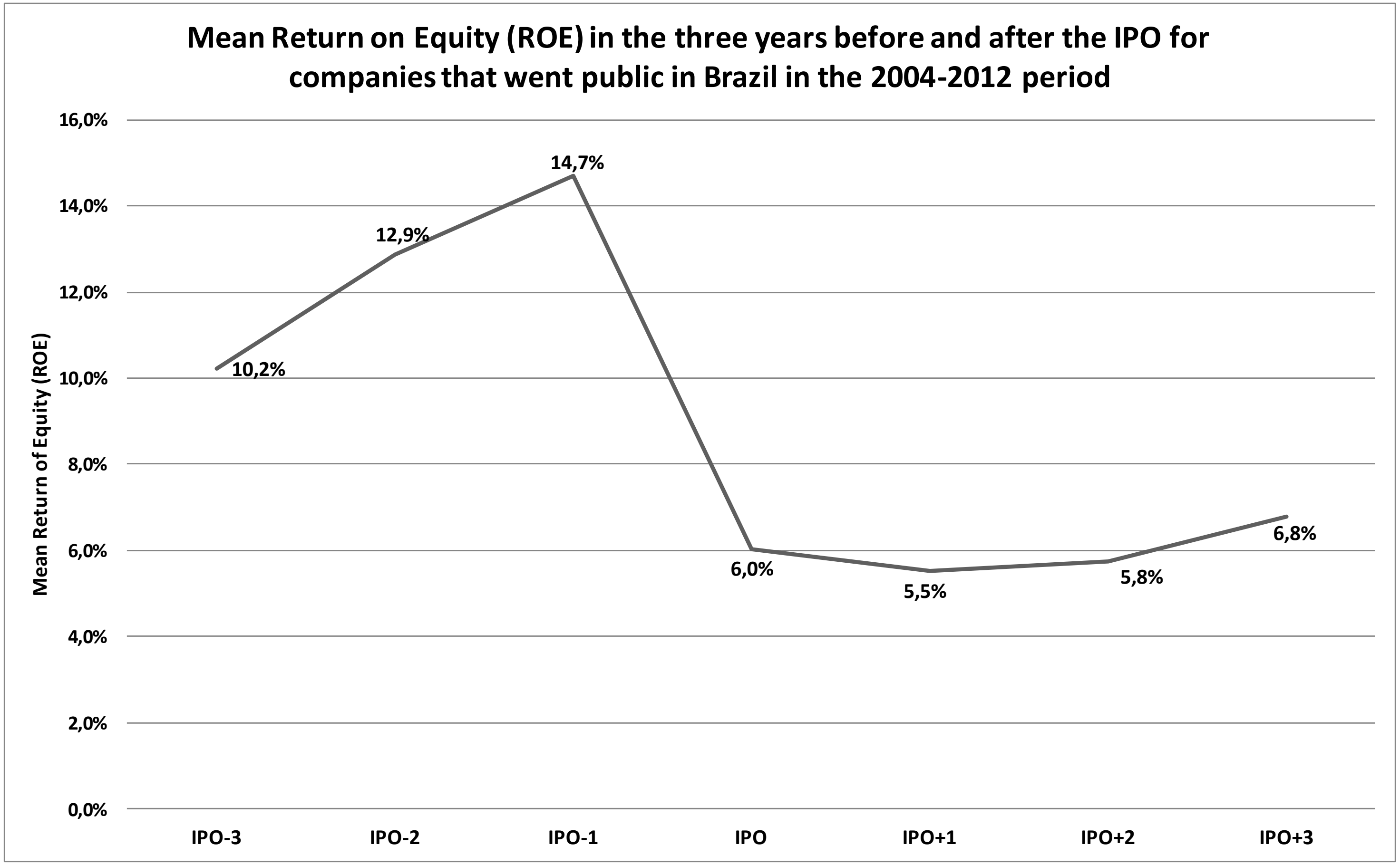
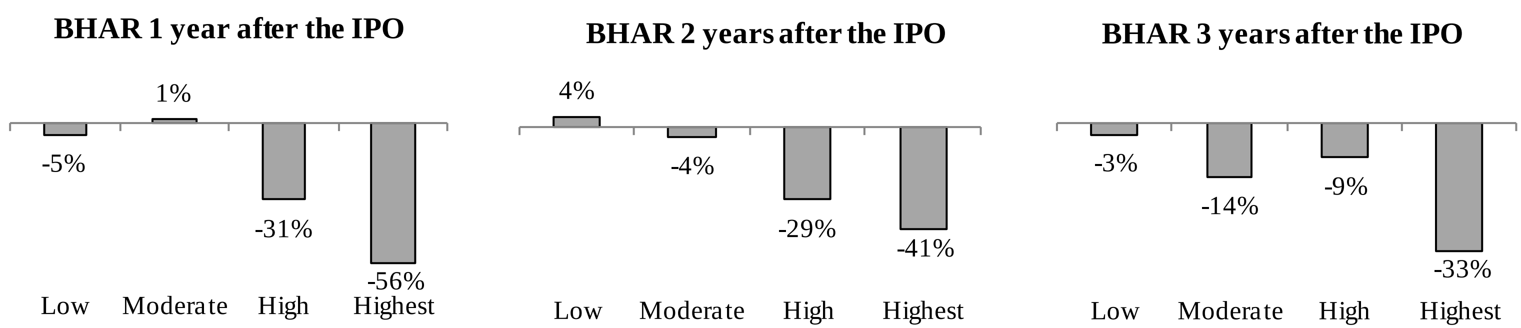


Post-IPO stock performance of companies depending on their pre-IPO relationships with their underwriters

IPOs with higher degrees of investor-underwriter conflict of interest are associated with market timing and lower post-IPO performance



Mean post-IPO buy-and-hold abnormal returns (BHAR), breakdown by degree of conflict. BHAR is defined as $R_{i,T} - R_{M,T}$, where $R_{i,T}$ is the stock i return, $R_{M,T}$ is the market portfolio return and the holding period T is one, two, or three years after the IPO. We use the Ibovespa stock index as the market portfolio. BHARs exclude the initial return on the first day of trading.

highest – when the return associated with the pre-IPO financing provided by the underwriter is highly sensitive to the offer price or to the success of the operation (e.g. derivatives attached to loan contracts, such as stock options, allowing the underwriter to collect sizable extra revenues shortly after the offer price is defined)

high – when the underwriter provides substantial pre-IPO financing shortly before the IPO the return of which is not highly sensitive to the offer price (e.g. loans contracted a few months before the issue)

moderate – when the issuer-underwriter pre-IPO relationship seems to have a long-term character and involves only regular underwriting or banking services, such as cash management and working capital financing.

low – when there is no pre-IPO relationship between any of the underwriters in the IPO syndicate and the issuer

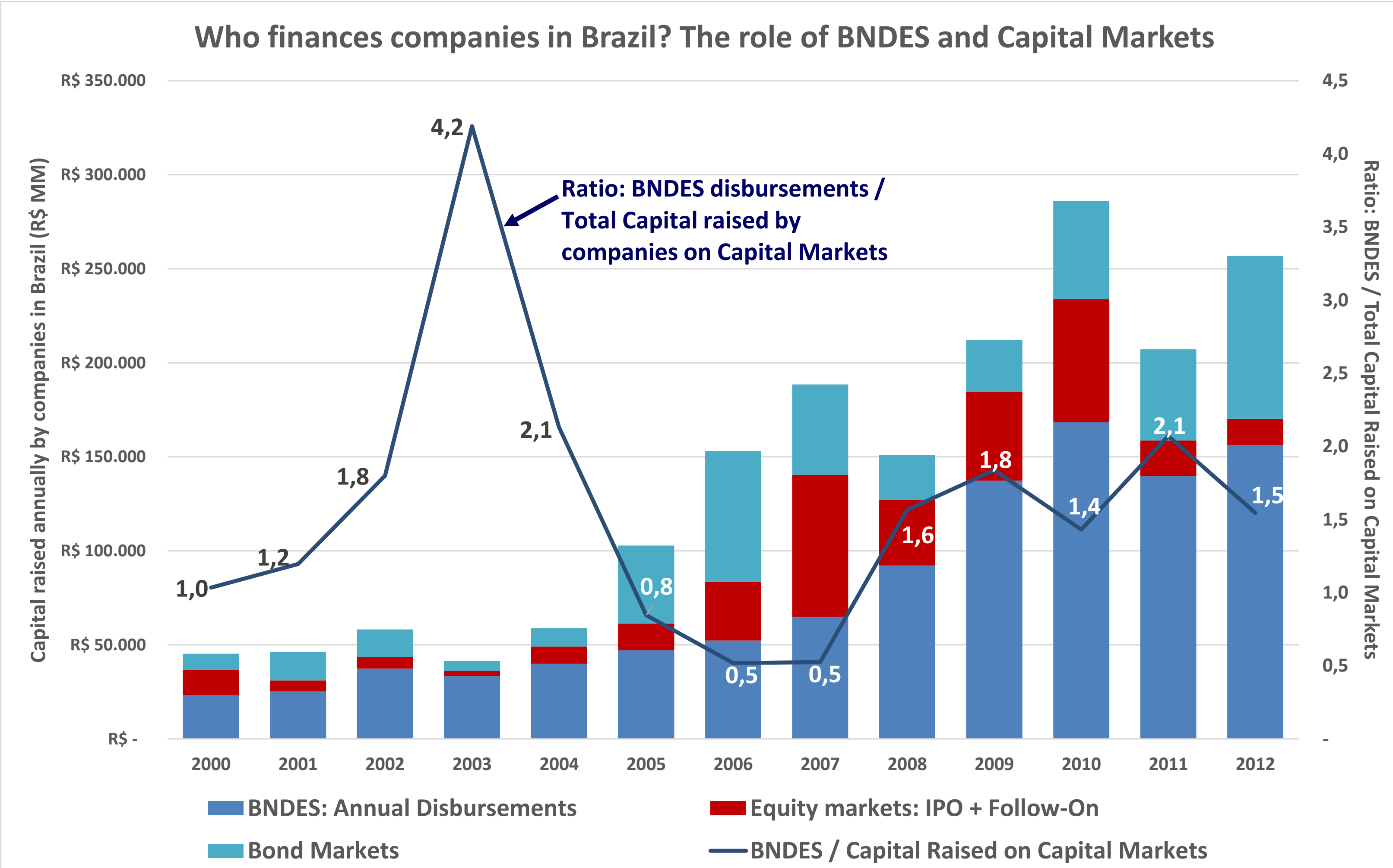
Source: Santos, R., Silveira, A., Barros, L. Investor-underwriter conflict of interest and post-IPO performance: Evidence of market timing and overvaluation of new issues. Working paper.

Top 10 IPOs in Brazil by capital raised from 2003-2013

#	Issuer name	Capital raised (R$ b)	Year	Issuer business description	Independent IPO?
1	Santander BR	13,182	2009	Carve-out from multinational listed firm	NO
2	BB Seguridade	11,475	2013	Carve-out from listed SOE	NO
3	Cielo (Visanet)	8,397	2009	Carve-out from financial institutions	NO
4	OGX Petróleo	6,712	2008	Family-owned conglomerate ("X" Group)	NO
5	Bovespa	6,626	2007	Demutualization of stock exchange	NO
6	BM&F	5,984	2007	Demutualization of stock exchange	NO
7	Redecard	4,643	2007	Carve-out from financial institutions	NO
8	BTG	3,234	2012	Founded by Brazilians, sold and bought back from UBS	Unclear
9	HRT Petróleo	2,481	2010	Independent IPO	YES
10	OSX Brasil	2,450	2010	Family-owned conglomerate ("X" Group)	NO

- These offers have collected 42% of all IPO proceeds in Brazil
- The concentration of Brazil's IPO market on non-independent IPOs has become even more pronounced after 2008… (64% of the capital raised to top 5 IPOs since 2009)

The BNDES as a major source of long term finance in Brazil



Obs.: In 2010, Petrobras raised US$ 70 billion in a share offer. Brazil's government received about US$ $43 bn in shares in exchange for allowing the company to drill for 5 bn barrels in reserves, I have only counted for around US$ 21 bn that have been actually raised with private investors in the capital market.

Questions deserving further investigation in Latin America (LA)

1. What is the relevance of economic groups in LA relative to the private sector as a whole? How do they finance themselves and what are their corporate governance practices (including RPTs)?

2. Who are the main institutional investors acting as shareholders in LA? How relevant has been the CG issues to their investment decisions? What has been their role in promoting higher corporate governance standards?

3. What are the main forms of control of LA listed companies (families, shared control, state, foreign, dispersed)? Need for an updated empirical overview

4. How diverse and active have been the boards of directors in LA? How this has changed over time and which countries have taken the lead on this?

5. Are underdeveloped capital markets a barrier to entry for small firms (and a competitive advantage for incumbents)?

How to transform primary equity markets in a true engine for growth?

Supply-side of Equity

Benefits of being listed > Costs

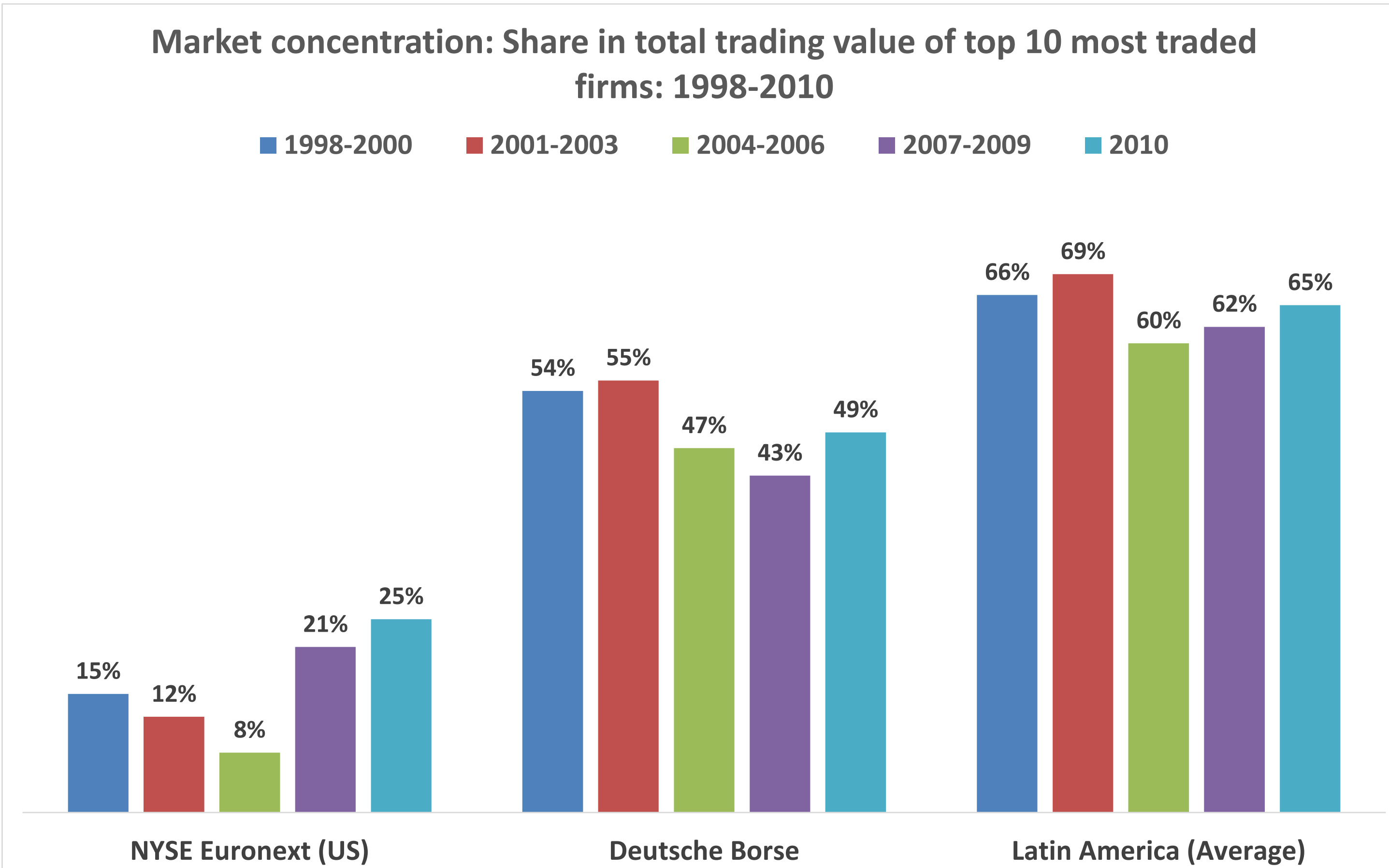
Firm-level perspective

Demand-side for Equity

Confidence that results will be achieved and that they will be fairly distributed

Investors' perspective

The current market structure in developed markets seems to be leading to an increased market concentration…



Obs.: The Latin America average has been computing based on the market concentration of the following stock exchanges: Buenos Aires SE, Colombia SE, Mexican Exchange, BM&Fbovespa, and Santiago SE.
Source: WFE – World Federation of Exchanges.