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Impact of Private Equity in Colombian Companies: A Case Study

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Abstract

A private equity fund is an investment vehicle managed by a professional team, whose main objective is to provide a medium or long-term return to its investors through capital investments in companies that are not listed on the stock exchange. In Colombia the first professional managers of private equity funds arrived in 2005, Since that date, several companies have been formed dedicated to this, such as Valorar Futuro, an investment fund which bought Aderezos and Higietex. The aim of this research was to determine the impact of the leverage of a private capital fund on the economic growth of a company. Financial balances of the companies Aderezos and Higietex were obtained from 2013 to 2017 and analyzed. Finally, it was found that the private capital fund allowed growth in the companies Aderezos and Higietex.

Keywords: venture, finance, private capital, investments, business

Introduction

Private Equity (PE) is a business model in which investors are associated with professional managers for the injection of private capital into companies, through the purchase of shares with the ultimate goal of obtaining a return about its investment through various disinvestment mechanisms (Chapple, Clarkson, & King, 2010; Meuleman, Wright, Manigart, & Lockett, 2009).

Some of the elements that make Private Equity (PE) a differentiated business model are (Ulloa, 2006) its structure of participation and roles, the average term of return on investment, and the mechanisms used to achieve the objective of your business model

Like all other for-profit businesses, the PE seeks to increase the value of the investment made. The way in which the PE works to achieve this objective is to invest in companies that are not usually listed on the stock exchange and some of which can not access bank financing or the capital market (Demaria & Tarradellas Espuny, 2016).

The structure of Private Equity is based on an asset management model, however, it is commonly accepted that one of the most distinctive features is its period of return on investment (3-10 years) (ASCRI, 2018) which is much higher than the fast money culture of Wall Street.

In the strict sense, the business of private capital was born with the first merchant companies destined to the exploration and exploitation of the American continent in the years before the 1900s, during this time the term Venture was coined which was a contraction of adventurer (adventurer) term with which they commonly referred to the people involved in these activities (Cendrowski, Petro, Martin, & Wadeck, 2012). The first great moment of the PE in the twentieth century occurs in the United States with the famous purchase of Carnegie Steel by JP Morgan in 1901 (Talmor & Vasvari, 2011). However, the business of PE as the industry we know today, was born in the eighties with the appearance of the so-called bootstrap acquisitions that later came to be known as Leveraged Buyouts in which essentially a buyer acquires its target financing through debt, a large part of the resources needed in the transaction (Hungarian Private Equity and Venture Capital Association, 2018). One of the main exponents and main precursor of this type of business is Henry Kravis, founding partner of the renowned private equity firm KKR, responsible for famous transactions such as the purchase of RJR Nabisco, producer of, among other products, Oreo cookies ("Henry R. Kravis," 2017).

In order to better understand the PE business model, it is important to know how the typical participants of a PE business and their relationships work:

Limited Partners: the typical investors of the Private Equity business are individuals or companies with the capacity to commit a significant level of capital and willing to have periods of return between 7 and 10 years. (Braun & Schmidt, 2014). Within these investors, it is possible to find pension funds, universities, private companies, government agencies and Family Offices such as Rockefeller, Rothschild etc.

General Partners: they are companies or people with extensive experience in the investment sector (Prowse, 1998), with administrative knowledge and valuable relationships that offer a competitive advantage to the investor when seeking to access the investment strategies pursued by the fund. In the Colombian case, under their regulation scheme, they can be professional managers, private companies, stockbrokers and investment banks. (Ministerio de hacienda y crédito público, 2015).

Administrators: the figure of administrator depends to a great extent on the jurisdiction where the business is being carried out, usually in the international market it is usually the same companies of the professional managers or Private Equity Firms that administer the funds through of legal figures as segregated accounts (Kaplan & Stro, 2009). In Colombia, there is a figure or fiduciary role that is reserved exclusively for a certain group of entities that are: fiduciaries, stockbrokers and Investment Management Companies (SAI) (Superintendencia financiera de Colombia, 2001).

The operation of the business model of a private equity firm can be divided into four stages [16], [17]:

- **Fundraising:** as its name says the Fundraising consists of the acquisition of investment capital for the private equity fund, generally during this stage, a professional manager establishes an investment strategy and carries out a marketing process known as roadshow to attract potential investors or limited partners and thus get the resources that are needed to execute the strategy (Andbanck, 2014).
- **Investment:** Consists in the constitution and formalization of all contracts associated with this business model, including the creation of the private equity fund in the management company, the remuneration and compensation structure of the manager, and the investment mandate and clawbacks, once the previous step is completed, the professional manager initiates the execution of the investment strategy (Liu & Yang, 2015).
- **Administration:** during this process the manager determines the specific investment opportunities that are in line with the fund's strategy and determines the allocation of capital to each of these opportunities, once this is done, the professional manager must exercise an active management of these investments seeking to meet the objectives agreed with their investors that at the end of the day is summarized in the increase in value of the capital received (EVCA, 2007). At this point it is worth mentioning that in addition to capital, private equity firms are also characterized by the proximity they seek to develop with the companies or businesses in which they invest, with the purpose of contributing their knowledge in good corporate governance practices, strategy and management, corporate finance, human resources management, etc.
- **Disinvestment (Exit):** in this period the manager makes the sale of the assets or businesses in which it was initially invested in order to materialize the value generated through the administration process, for this purpose the manager has several tools that are: OPI (Initial Public Offer), sale to another Private Equity and sale to a strategic buyer M & A (Mergers and Acquisitions) (Johan & Zhang, 2016).

- Like all financial businesses, PE firms face different risks that they must seek to mitigate or reduce. Among these we can typically find the following (Diller & Jäckel, 2015):
- Liquidity risk: Given that investments under a PE business model are in assets that are not generally listed on the stock exchange, this makes it more difficult to execute an early exit from the investment, which is configured as a liquidity risk.
- Concentration risk: This consists of the existence of a large concentration of capital in a single investment strategy, a situation that arises from the need to have management capacity in the same investment (company). That is to say, "there are many eggs in the same basket".
- Risk of adverse selection: This is that, having a limited number of investment options, there is a greater likelihood that the decision and its performance are sub-optimal.

In Colombia, the first professional managers of private equity funds to arrive were LAEFM Colombia (LAEFM Colombia, 2018) and SEAF Colombia (SEAF Colombia, 2014), in the year 2005. After this arrival, the first regulations for the development and regulation of the industry were made. The first regulatory framework of the industry was made under resolution 470, where pension funds were granted permission to invest in these private equity funds.

Taking the study carried out by the firm Ernst & Young and ColCapital, we can find that since its inception, the private equity fund industry has shown a constant increase (ColCapital & EY, 2017).

A couple of cases of Colombian companies in which investments were presented by private equity funds are:

Tribeca purchased stakes in Emi and Onda de Mar through its Private Equity Fund FCP Tribeca Fund I, managed by the fiduciary Fiducor (Tribeca, 2018).

SEAF and SEAF Colombia they bought participations in Mimo's and Kokoriko through the participation of Grupo Conboca through their private equity fund MAS COLOMBIA-LATAM

In the year 2012, the firm Valorar Futuro bought the company Higitex Ltda., and in 2013 bought Ascender S.A.

The aim of this study was to determine the impact of the leverage of a private capital fund on the economic growth of a company, where the companies Ascender S.A and Higitex Ltda in Colombia will be taken as a case study

Methods

The financial statements of Ascender SA and Higitex Ltda, from 2013 to 2017, were taken from the Colombian Superintendence of Companies. Once obtained, a database was assembled and the main accounts were selected in order to calculate the financial indicators.

The selected accounts were: operating income (OI), gross profit (GP), operating profit (OP), net profit (NP), EBIT, invested capital (IC), and equity (E).

Variations in operating income, gross profit, operating profit and profit and loss over the years were determined (1). And the financial indicators such as gross margin (2), operating margin (3), ROE (4) and ROIC (5) were calculated

$$VTY(\%) = \left(\frac{\text{Current year}}{\text{Last year}} - 1 \right) * 100 \quad (1)$$

$$GM(\%) = \frac{\text{gross profit}}{\text{operating income}} * 100 \quad (2)$$

$$OM(\%) = \frac{EBIT}{\text{operating income}} * 100 \quad (3)$$

$$ROE(\%) = \frac{\text{net profit}}{\text{equity}} * 100 \quad (4)$$

$$ROIC(\%) = \frac{EBIT}{invested\ capital} * 100 \quad (5)$$

Where VTY is the variation of the indicator through the years; GM is the gross margin; OM is the operating margin; ROE is the return on equity, and ROIC is the return on invested capital.

results and discussion

Salsas Aderezos is an Antioquia food company that is part of the Ascender S.A. business group. He has also had a wide selection in the country with presence in more than 5 main cities. The company was founded in 1994 and in 2013; the purchase process was started by the private equity fund Valorar Futuro. On the other hand, Higietex is a company dedicated to the production and marketing of cotton products for personal care and health. It has been in existence for forty years and is one of the most recognized brands in this sector in Colombia. Currently exports to South and Central America. This company was purchased by the private equity fund Valorar Futuro in the year 2011

After receiving the support of the Valorar Futuro capital fund in the financial balances of the company Aderezos (table 1), a continuous growth in its income can be evidenced. Between 2013 and 2014, revenues grew approximately 7.1%, while for the 2014-2015 period, revenues grew by approximately 11.5% and finally for the 2015-2017 period, they rebounded with 31%. This is also reflected in the increase in its cost of sales, with an average growth of approximately 23% as of 2014, which supports its continuous increase in sales.

Table 1. Financial statements of the company Aderezos for the years 2013 to 2017.

	2013	2014	2015	2016	2017
OI	\$5,467	\$5,854	\$6,525	\$85,665	\$11,279
GP	\$2,713	\$2,870	\$3,256	\$3,914	\$5,325
OP	\$1,073	\$866	\$1,031	\$1,467	\$2,354
NP	\$536	\$160	\$300	\$807	\$1,317
EBIT	\$1,073	\$866	\$1,031	\$1,467	\$2,354
IC	\$1,477	\$1,325	\$1,172	\$1,747	\$2,152
E	\$1,451	\$1,093	\$813	\$1,346	\$1,938

The values are given in dollars

Respecting to the gross margin, the company shows a constant behavior between 2013 and 2015 with an average of 48% (Table 2). The company presents a constant behavior between the years of 2013 to 2015 in its operating margin, with an average behavior of 18%, and an increase between 2016 and 2017 of almost 4 percentage points, showing a significant increase in sales and even above their costs and expenses. The company presents a significant increase in its ROE for the period between 2015 and 2016, as it goes from average levels of 30% to average levels of 64%. Finally, between 2016 and 2017, the ROIC presented an approximate variation of 25%, which indicates an increase in the profitability of the funds invested in the assets, whether they are of patrimonial origin or long-term loans.

Table 2. Financial indicators of the Company Aderezos for the years 2013 to 2017.

	2013	2014	2015	2016	2017
GM	49.6%	49.0%	49.9%	45.8%	47.2%
OM	19.6%	14.8%	15.8%	17.2%	20.9%
ROE	36.9%	14.6%	36.9%	59.9%	67.9%
ROIC	72.7%	65.4%	87.9%	84.0%	109.4%

The purchase of the company Aderezos by the private equity fund Valorar Futuro allowed a change in the management of the company (ceasing to be a family business), allowing improvements in its processes, which can be seen in the increases of its indicators.

Between 2016 and 2017, the company showed significant growth in its income levels and indicators such as the operating margin and the ROE. Additionally, it underwent changes in its brand image, seeking to respond to new marketing strategies proposed by the professionals of the private equity fund.

It can be said then, that the greatest impact of this purchase is the change in its management and as a result the increase in its revenues, the product portfolio and the arrival in new markets.

On the other hand, the Higietex Company, after receiving the income from the Valorar Futuro fund, showed a continuous growth in income, between 2013 and 2014, revenues grew approximately 1.8%, while among the year 2014 to 2015 they grew approximately 13.9% and finally between the years 2015 to 2017, they grew on average 28.4% (Table 3).

Table 3. Financial statements of the company Higietex for the years 2013 to 2017.

	2013	2014	2015	2016	2017
OI	\$4,142	\$4,216	\$4,802	\$5,585	\$6,261
GP	\$1,430	\$1,596	\$1,947	\$2,148	\$2,297
OP	\$78	\$241	\$528	\$696	\$789
NP	\$-201	\$-12	\$284	\$387	\$425
EBIT	\$78	\$241	\$528	\$696	\$789
IC	\$1,176	\$118	\$1,198	\$1,239	\$1,525
E	\$855	\$82	\$536	\$372	\$249

In terms of gross margin, the Higietex Company showed a constant average behavior of 37.6%, with a slight growth in 2015 of 3 percentage points. Likewise, it presented an average increase of 12% in its operating margin as of 2015, showing an improvement in its operational and administrative expenses.

Higietex showed a significant increase in its ROE as of 2015, since this goes from negative levels to positive and maximum levels of 44.6%. As of 2014, the ROIC showed a significant increase, going from levels lower than 10% to levels higher than 20%, reaching its peak in 2016 at 56.2%, which shows an improvement in the profitability of the funds invested in the assets, either of their patrimonial origin or of long-term loans (Table 4).

Table 4. Financial indicators of the Company Higietex for the years 2013 to 2017.

	2013	2014	2015	2016	2017
GM	34.5%	37.9%	40.6%	38.5%	36.7%
OM	1.9%	5.7%	11.0%	12.5%	12.6%
ROE	-62.8%	-3.5%	42.9%	44.6%	33.3%
ROIC	6.7%	20.5%	44.1%	56.2%	51.7%

For both Aderezos and Higietex, after receiving the capital injection by Valorar Futuro, there may be evidence of a growth in its operating revenues, which is evidenced by an increase in selling costs at the company Aderezos. However, in Higietex a decrease in its sales costs can be evidenced, which could have occurred when performing an efficiency in obtaining raw material and direct labor, also, a reduction in operating income between 2016 and 2017 can also be seen, which could be presented by an increase in its operating expenses.

In terms of total assets both companies showed growth year after year, for the company Aderezos an average growth of 21.5% was obtained, while for Higietyx a constant growth of 16.8% was obtained, which could conclude that in some the injection of capital allowed the acquisition of assets that leveraged the growth of the company. As for liabilities, both companies showed a decrease starting in 2016.

Conclusions

The private capital funds allow the growth of small businesses or family businesses; this was reflected in the case study of the company Aderezos, where its indicators saw an increase, due to several factors influenced by Valorar Futuro, such as improvements in the brand, consulting in business management, product diversification, among others. The in-depth study should be followed with other cases that allow evaluating the influence of these private funds on small companies in Colombia and making a comparison with other countries.

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