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Performances of Brazilian IPOs backed by private equity

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ABSTRACT

Private equity funds invest actively. According to the literature, their portfolio companies maintain superior transparency standards and corporate governance practices, such as keeping independent board members and hiring international auditing firms. Private equity funds require either a controlling interest or restrictive clauses to limit managerial action and usually appoint the executives of their portfolio companies. Brazil faced an IPO wave that started in 2004 and peaked in 2007. Many private equity deals went public. The aim of this paper is to investigate whether private equity backed IPOs performed better in the long run (1 year) than non-private equity backed IPOs. We examine the one-year cumulative abnormal returns (CAR) of 108 Brazilian IPOs from January 2004 to June 2008, including 42 PE backed IPOs. We split the sample into two calendar periods: 2004–2006 and 2007–2008, and we find that PE backed IPOs have higher average CAR than non-PE backed IPOs in both periods. However, PE backed IPOs issued during 2007–2008 were not immune to the 2008 world economic crisis and investments in the smallest companies are the ones most severely affected. Regression analysis confirms that PE investment has a positive relation to CAR, but only for IPOs issued in 2004–2006.

1. Introduction

Brazilian investors, regulators and legislators have adopted many measures to improve the institutional environment in the last decade. In 2000, Bovespa created the differentiated Stock Listing Segments for Brazilian Companies according to the way they practice Corporate Governance: Level I, Level II and New Market. In 2004, Brazil launched the New Bankruptcy Law (similar to Chapter 11). Since 2005, the Brazilian Supreme Court (STJ) has recognized conflict resolution by Arbitrage Chambers. During this period, Brazil also showed consistent improvement according to economic indicators. A better institutional environment and good economic indicators allowed Brazil to benefit from international liquidity since 2004, and its stock market boomed. Table 1 illustrates the development of stock issues in Brazil. From 2004 to 2008, Bovespa had 160 public offerings, IPOs and follow-ons, totalizing BRL at 148 billion, compared with the period between 2002 and 2003 when only 14 stocks were issued, totaling BRL at 6.7 billion. Primary offers account for only 7% of the total offers between 2002 and 2003, and 58% between 2004 and 2008. Issues concentrate highly in 2007, a year that accounts for 44% of the total volume of issues from 2002 to 2008.

Brazilian private equity and venture capital funds invested US $1.9 billion between 1999 and 2004 in different sectors according to Carvalho, Ribeiro, and Furtado (2006). The IPO window allowed many funds to exit through the public market, a possibility that was practically inexistent before 2004.

Private equity and venture capital funds are investment vehicles managed by general partners. General partners are responsible for raising funds with the limited partners, selecting, investing and monitoring the companies within the portfolio. Usually the general partners invest capital in the portfolio companies by buying new shares and maintaining an equity stake, but sometimes they employ other instruments such as convertible debt, calls, puts and warrants. They usually keep their equity stake in the portfolio companies for a limited time of 5 to 7 years. When the general partners liquidate their stake in the portfolio companies they return the invested capital plus profits to the limited partners

As the funds have a limited life (usually 10 years), PE/VC organizations have to raise new funds from time to time in order to maintain their business. The average return of the top performing funds is much higher than the lower performing funds (see Kaplan & Schoar, 2005), and different from the public market, there is a significant consistency in the PE/VC performance. Therefore, the PE/VC records of accomplishment predict future performance, and a good reputation is essential for raising new funds. Good performance means a rate of return significantly higher than what could be obtained in the public market. In order to achieve superior performance, general partners need to select promising companies as well as talented entrepreneurs and managers to develop or grow their business.

General partners appoint the executive officers and board members, pressure portfolio companies to achieve growth rates and performance

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