Colombia: Ten Years of Development of the PE Industry

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Introduction

Colombia's PE industry has reached its first decade (2006-2016). Incorporation of local funds has been successful for an emerging economy, placing Colombia in the spotlight of foreign and domestic GPs willing to incorporate local PE vehicles or to raise capital from local investors, specifically in the real estate and infrastructure sectors. Simultaneously, local investors such as pension funds and insurance companies are increasingly seeking attractive PE opportunities offered by international managers abroad.

As of May of 2016, the Colombian PE association - Colcapital[2], reported 82 domestic funds with a total committed capital of almost US$22.000 million, representing an increase of 15% with respect to May of 2015. Of this amount, 54% is associated with domestic investments, of which nearly US$6.7 million are already invested, leaving US$5.3 million available to invest.

Development Per Sector: Infrastructure and Real Estate

Colombia currently has 11 domestic infrastructure funds with total committed capital of US$5.2 million. This represents a 100% increase on the existing infrastructure initiatives with respect to 2015, that obeys to the significant demand for private financing of infrastructure projects derived from the US$15 billion 4G toll-road program sponsored by the Colombian government.

In fact, the Colombian government has put in place a robust infrastructure program, focused not only on roads but also on other sectors such as airports, rail, ports, mass transportation systems, hydrocarbons, gas and energy. Pursuant to the *Financiera de Desarrollo Nacional*, the infrastructure sector needs approximately US$25 billion to finance infrastructure projects in the following years. The Colombian government has only US$4 billion, which represents a huge opportunity to other investors such a local and foreign PE funds.

1. Brigard & Urrutia is a leading full-service business law firm in Colombia. www.bu.com.co
2. Our special thanks to the Asociación Colombiana de Fondos de Capital Privado - Colcapital for providing us with the necessary industry information to produce this article. Colcapital is constantly monitoring the evolution of the industry, producing consolidated and comprehensive information to facilitate the analysis of the evolution of PE industry in Colombia.

With these figures and because the Government hosted a series of clear regulations such as the PPP Act and the creation of the National Agency of Infrastructure - ANI, world-class infrastructure developers are now encouraged to invest in 4G projects. This kind of action also boosted the participation of key investors, such as multilateral agencies, sovereign funds and offshore pension plans, who had previously been absent from Colombia's infrastructure landscape.

More particularly, this constant necessity available capital to finance the different infrastructure programs triggered two regulatory modifications in the local pension funds investment regime. In 2015, the Ministry of Finance issued Decree 1385 that created a specific allocation for local pension funds to invest in local PE infrastructure funds. Subsequently, in 2016 the Ministry issued Decree 765, which created a new asset class defined as alternative investments with its own mandate to invest in infrastructure assets. PE funds were included within this new bucket in an attempt to stimulate investments in local private equity funds.

On the other hand, since a few years ago, good and steady prices and a rising middle class accessing the real estate sector has confirmed the interest of local investors such as pension funds, insurance companies and family offices, as well as the awareness of local and foreign GPs. Currently, in Colombia there are 22 local real estate Funds, with total commitments of US$2.042 million, representing an increase of 56% with respect to 2015. Local real estate funds are managed by important local developers and large economic groups, such as Santo Domingo's family through Terranum, Inverlink, Amarilo, Jaguar Capital and important financial groups such as Bancolombia, Credicorp and BTG Pactual, and the recent alliance of Argos and Conconcreto through Pactia. In addition, foreign groups such as Paladin and Jamestown are willing to raise capital in the country and are also thinking about the possibility of incorporating a local vehicle.

Other kinds of vehicles such as buy-out funds or venture capital initiatives also have a positive but much steadier perspective. Local pension funds are skeptical of committing additional capital, since exits from existing first vintage funds are only until now, occurring and have not been as frequent as desirable. In fact, the Colombian PE industry is still waiting for an outbreak of numerous and successful exits. In addition, the venture capital industry is still taking off and faces some concerns with respect to typical PE. Local fund structures are expensive for entrepreneurs and investors are not increasingly willing to sponsor early stage projects. With this in mind, local incubators such as Ruta N, Innpulsa, Fundación Bavaria and the Colombian branch of NXTP Labs have made enormous efforts to foster venture capital and risk investments. Therefore, there has been an increase of 53% local venture vehicles with respect to 2014, with 9 venture funds representing US$89.5 million.

There are some examples of GPs raising second or third generation funds (for example, Altra, MAS Equity Partners, Tribeca, Terranum Capital), which demonstrates the confidence of local investors, especially pension funds, insurance companies and family offices in the PE industry. However, this trend will be stronger once the exits wave is ratified with good results and GPs demonstrate their ability to successfully disinvest a PE fund.

Finally, the Colombian PE industry is reaching an initial level of maturity that permits some entities such as Bancoldex[3] to explore the possibility of incorporating the first Colombian fund of funds with a Latam regional scope. This proves that governmental authorities like Bancoldex are willing to become general partners and assume the fiduciary responsibility derived of such a role to cooperate with the development of an industry like PE that is in constant growth.

General Regulatory Framework

From a legal perspective, Colombia's private equity regulations are well developed and are contributing to the development of a robust domestic industry. The *fondos de capital privado* regime has been in place since 2007 when domestic pension funds were allowed to invest in private equity and pooled fund structures. In 2015 Colombia maintained its standing in the annual LAVCA Scorecard which rates the attractiveness of Latin American countries for private equity. Colombia has 61 points (out of 100) and is ranking as the fourth strongest environment in Latin America for the development of private equity (only after Brazil, Mexico and Chile)[4].

The structure of local private equity funds is consistent with global market practices, having a similar general-limited partner structure, and with an additional

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3. Bancoldex S.A. is the national development bank.
4. The Latin America Venture Capital Association (LAVCA) Scorecard on the Private Equity and Venture Capital Environment in Latin America and the Caribbean, available at www.lavca.org

administrative figure in charge of a local supervised financial entity (mainly for back office purposes). General partners do not have to be registered companies but must demonstrate at least five years of experience in managing private equity investments. Although local regulation requires the presence of a local administrator supervised by local regulators, it can be said that these entities have been in constant evolution and the sophistication of their operations and back-office activities, which creates fluid relationships with GPs.

Regarding their incorporation process, private equity funds are not subject to a prior approval of the local regulator and are required only to file certain documents with the Colombian Superintendent of Finance to begin operations. Although during certain years the process was not as efficient as defined in the regulations, the Superintendence of Finance has finally adopted the non-objection 15-day period for a faster and easier set up of local funds.

It is worth commenting also that during 2014 and 2015, appraisals and valuation of portfolio assets was the center of attention of all PE stakeholders. The local regulator implemented a third party registered-valuator figure (*proveedor de precios* or official price vendors) that intended to implement an objective valuation process free from potential conflicts of interests. However, GPs and investors raised their voices against an expensive and non-practical structure in which valuations had to be done by a third party with no experience in the sector in which the fund was invested. Bearing this in mind, the local regulator recently enacted a new rule (Circular 015 of 2016) that permits the Fund to voluntarily adopt the registered price vendor figure or to delegate valuation in the GP or any other independent investment bank, aligning Colombian practices with international standards.

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Competitive Taxation Regime

With respect to tax regulations, the local private equity industry benefits from some competitive advantages that serve to attract foreign investment. Carried interest income is treated as capital gains and not ordinary income and is generally subject to a tax rate of 10%. In addition, the fund itself is not subject to income tax (*“Transparency Principle”*) and therefore distributions to the investors are taxed as direct gains of the investors depending on whether they are Colombian or offshore residents and particularly, depending on the taxes being paid by each of the underlying assets of the fund. Also, PE Funds are proper deferral instruments to only pay taxes once actual profits are distributed to investors, because the conventional PE waterfall is accepted and distributions made by the Fund may be accounted first as a return of capital, allowing efficient tax planning structures whereby profits are reinvested indefinitely without taxes.

Colombia General Overview

The improvement of security conditions in recent years has contributed to the re-establishment of investors’ confidence in the country, particularly in light of the end of a 50-year conflict with local communist guerrillas in August 2016. In accordance with the International Monetary Fund, “despite facing a terms-of-trade shock larger than most of its peers, Colombia posted one of the highest growth rates in the region and achieved important social gains with improvements in poverty reduction and income inequality”[5]. However, Colombia’s economy will grow only 2.5% compared to 4.45% in 2014 and 3.1% in 2015 due to the drop in oil prices, which had a hard impact on the national economy making tax reform necessary to fill the hole in central government’s budget.

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5. International Monetary Fund, “Colombia: Concluding Statement of the 2016 Article IV Mission”. March 16, 2016. www.imf.org.