BASIC KEYS TO CONSIDER WHEN STEPPING INTO THE ARGENTINE PRIVATE EQUITY ARENA

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THE ARGENTINE ECONOMIC AND POLITICAL SCENARIO.

The economy's fundamentals. Argentina's GDP grew from 2003 to 2007 at annual rates higher than 8%, barely declining to around 7% in 2008[1]. However, the global crisis accelerated the end of such impressive growth cycle, and the GDP's evolution for 2009 is expected to be close to cero[2]. Meanwhile, the annual inflation level is in between 15 to 20 percent[3], and the quotation of the U.S. dollar as of mid August 2009 is around Pesos 3.85 to the Dollar[4]. In this scenario, treasury reserves amount to approximately US$ 45,000,000,000[5], which allows the government to maintain its grip for the time being. In any case, the economy's fundamentals remain adequate, with surpluses both on the fiscal and current accounts, even if threatened by the voracious rise in public expenditure.

Probably the near future of the Argentine economic scenario will highly depend on the evolution of the agribusiness commodities' prices, since Argentina's annual exports on such sector keep growing year to year, and could feed a population of more than seven times Argentina's forty million people. Experts say that as China and India's populations keep increasing their access to the consumption markets, agribusiness will keep blooming[6], thus continuing its substantial and positive impact on the Argentine GDP. Even though Argentina faced a drought during 2009 that severely affected crop yields, such a situation was circumstantial and has not affected investments for the 2010 campaign. Besides, not only traditional primary commodities have been leading the Argentine recovery, but also Argentine exports of manufactures (for example, automobiles, food and beverages, and design products) and value added services (such as information technologies, professional consultancy, and tourism) are expanding.

Based upon the foregoing, and despite the government's unorthodox methods and lack of credibility, economists forecast that Argentina will return to growth during 2010, even if not at more than at a modest rate[7].

Foreign debt: restructured but still a stigma? Argentina's foreign debt was defaulted in late 2001, and restructured in 2005. As of August 2009, such restructured debt amounts to approximately US$145,000,000,000[8]. Holdouts to such restructuring amount to about US$ 31,000,000,000, and they have initiated legal actions seeking enforcement. Government sources have let slip that the government is about to initiate a road-show in order to perform an offer comprising what is expected to be around a 75%-cut payment to such holdouts.

In 2006, IMF´s debt was cancelled, mostly for political reasons, but Argentina still owes around US$ 7,000,000,000 to the Paris Club, and such outstanding and unpaid debt remains an issue. Rumors indicate that the government is unofficially negotiating with the Paris Club.

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[1] www.fiel.org / www.mecon.gov.ar

[2] The Economist (www. economist.com country briefings - Argentina). Also, Export Development Canada (*www.edc.ca/english/docs/g**argentina)***

[3] The National Office of Statistics and Census informs figures around an annual 7.2 per cent, but economists agree that the right figure represents more than twice the official number.

[4] www.bcra.gov.ar

[5] www.bcra.gov.ar

[6] Rabobank (Netherlands). Rabobank predicts strong growth in worldwide food and agriculture industry (07/24/08)

[7] See footnote No. 2.

[8] www.mecon.gov.ar / www.bcra.gov.ar

In such scenario, access to sovereign debt markets for Argentina that has remained partially closed could be reopened.
In any case, for the time being, insolvency fears disappeared since the Government: (i) fixed a local exchange over guaranteed loans this year; (ii) is launching a bond SWAP offer, which is widely expected to succeed, and upon which it shall obtain postponement of several 2009 and 2012 debt obligations; (iii) has been paying its external debt obligations when due; and (iv) has nationalized the pension funds system, thus gaining access to a substantial cash source. In addition, despite the recent international turmoil and credit crunch, Argentina's fundamentals remain stronger than those of many emerging markets. As to the financial system, the level of credit was very low even before the international credit crunch since the Argentine economy is usually not leveraged on credit, thus resulting in a low and segmented impact of the international credit crisis within the Argentine financial markets.

Devaluation and inflation. Devaluation process and foreign exchange control have been wisely and highly professionally controlled by the Central Bank of Argentina, avoiding sudden fluctuations typical during world financial crisis in developing countries.

Inflation on the other hand may present a problem in Argentina. The INDEC (National Institution of Statistics and Census) official statistics lack credibility, and private sector resorts to prestigious non-governmental institutions for trustworthy statistics. This situation though, may be corrected in the future.

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Nationalization of the pension funds. The pension funds system nationalization by the end of 2008 allowed the government access to all of the pension system's flow of funds. The pension funds used to be a substantial source of money in the Argentine capital markets, but after the nationalization, all such inflow of money shall not necessarily be destined to the Argentine capital markets, but rather to certain sectors deemed strategic by the government, such as infrastructure, energy and public works. Such drought in the capital markets is detrimental to the already almost inexistent credit market, and is bound to generate, at least indirectly, benefits and opportunities for private equity.

Official defeat in mid-term elections. In June 2009, Argentina's president Cristina Kirchner suffered a defeat in the mid-term elections, which ended her control of congress and exposed disenchantment with her governing style and policies. She lost her grip on the legislature and also on the Peronist party, since voters also rejected her husband and predecessor, Néstor Kirchner, in a high-profile congressional race for the Buenos Aires province. Allies also lost the elections in key districts. As a consequence of such a defeat, the president reshuffled her cabinet to try to wrest back the initiative ahead of the 2011 presidential election.

Energy crisis. In order to maintain popularity, after the 2001 turmoil, the Government freezed tariffs of key public services, but this measure stopped investments in the oil, gas and electricity industries, triggering a steep decline in production and leading infrastructure private investments to a virtual stop. If no changes are made rapidly, in 3 or 4 years, Argentina could turn to be an oil-importing country.

OPPORTUNITIES FOR PRIVATE EQUITY IN THE UPCOMING ARGENTINE SCENARIO.

Faced with the economic crisis that started in the developed countries, Latin American countries, and particularly Argentina, are now in a more solid position than in prior cycles, thanks to high savings rates and low leverage levels.

While demand of goods and services are expected to slow down, demand for relatively inelastic goods such as food and basic materials looks healthy, mostly due to the rise of consumption in Asia. Argentina is in a privileged position to feed such demand, thanks to ample natural resources, state-of-the-art agribusiness technology and know how.

In this context, as capital inflows into Argentina have been relatively insignificant, and availability of long term financing has evaporated since the financial crack in the central countries, opportunities for long term investors in Argentina abound.

Some sectors of the economy are wealthy, while others are craving for capital either to grow or to survive. It is key to detect business opportunities within the money craved sectors, in order to attain compliance with a rule that is of the essence: make sure you buy cheap.

INITIATIVES OF THE PUBLIC AND PRIVATE SECTORS.

The National Investment Development Agency ("Prosperar"), an office created by the end of 2006 under the jurisdiction of the Ministry of Economy, has created a Program for the Development of Venture Capital. The difficulties in obtaining access to credit, and the costs and bureaucracy to be faced when setting-up a start-up requires the State sector to provide some aid to investors, either in the seed capital stage, as also in the start-up stage and in the first years of evolution of companies with high-growth potential. Prosperar, which is doing a good job in promoting investment opportunities in Argentina, is a confirmation that Argentina holds promotion of private equity investments as a public policy priority.

Also, the Argentine Venture Capital and Private Equity Association (ARCAP) creation in 2009 was welcomed by the private equity funds with interests in Argentina, most of which are a party to this Association. The purpose of the Association is to seek solutions to the sector's problems, and to promote venture capital and private equity investments in Argentina.

FEATURES OF TYPICAL ARGENTINE TARGETS FOR PRIVATE EQUITY.

Private equity investments in Argentina usually target family controlled companies that have grown substantially and that are either in financial distress or facing troubles in the transition of one generation to the other. Successful family-run companies with no financial distress and no transition troubles are seldom willing to surrender equity, and when they do, it is usually upon a tempting offer.

It is very important to obtain some first-hand knowledge of the company structure and rules both formal and informal of its control and of management (the latter being generally intertwined with the controlling family, at least to a certain degree) before even planning the first move. Within this scenario, investors should plan what will be the course of action after the acquisition as regards to management and members of the family involved in the corporate structure, and how to convert the family-controlled business culture into a culture and environment suitable to the standards of the acquiring party.

It is also important to bear in mind that management's practices, performance and legal compliance standards may be lower than those expected by the acquiring party.

KEY STRATEGIES FOR SUCCESS.

- Start at the end: plan your exit. Even though private equity investors tend to think of IPOs as the main exit, Argentine history indicates that there are not many cases that have ended with IPOs. Therefore, make sure that there shall be realistic alternatives when wishing to exit: enter into a registration rights agreement, but also negotiate put options, tag or drag along provisions (as convenient in each case), and analyze if the relevant market will count with enough strategic buyers when exit is sought. Do not fall into the liquidity trap.

- Retain local counsel with extensive M&As expertise. Many legal steps of the transaction will not differ in the essence much from those steps applicable to a U.S. M&As deals, but not counting with local counsel with expertise in the matters that need to be addressed in Argentina could cost you your investment.

- Perform a thorough due-diligence. Focus mainly on (i) corporate matters (analyze by-laws and verify if the Stock Ledger Book, the Attendance to Shareholders Meetings' Book, the Shareholders Meetings Minutes' Book and the Board Resolutions Minutes' Books have been adequately filled and executed), (ii) adjustment of the financial statements to the situation of the company (check if all the assets and liabilities are adequately reflected in the FS), (iii) tax matters, (iv) labor matters (ask for a list of all employees, with a detail of wages, seniority and positions, also pay particular attention to services agreements, non registered relationships, agreements with key employees, golden parachutes, bonuses payable to management upon the closing of the deal), (v) contract matters (pay particular attention to change of control provisions and to agreements with no specific term or long term and no non-cause termination provisions), (vi) property, including real estate and tangible assets (pay particular attention to mortgages, chattel mortgages and pledges, encumbrances and liens), (vii) trademarks, patents and other industrial property, (viii) court claims and other claims against the company, (ix) compliance with environmental laws (if applicable), (x) compliance with specific legal frameworks applicable to the company's sector, and (xi) conditions precedent to the closing (such as antitrust clearances if applicable to the particular case, and other governmental approvals, also if applicable to the particular case).

- <u>Make sure the price is convenient</u>. Although the entry price is not the only relevant matter to guarantee a good chance of success, orthodox practice indicates that convenient price is a must.

- <u>Try to obtain control. If you do not, then make sure you mitigate risk</u>. Even though acquisition of minority stakes have been usual in the past and still happen, Argentine history taught a few sour lessons, indicating that it is convenient to acquire control.

  Nevertheless, if the investment target is a minority-stake, it is key to bear in mind that the Argentine legal framework is not as protective to minority shareholders as the legal framework of the U.S. In such case, mitigate risk by conditioning the deal to the execution of a Shareholders' Agreement ("SHA") granting you a place in the board, veto rights and supermajorities both in respect to board resolutions and shareholders resolutions, as also right of first refusal or right of first offer provisions, tag along provisions, deadlock provisions, put & call options, resolution of disputes and other customary provisions. Bear in mind that the SHA shall be advisable even in case you acquire control, but should such be the case, the matters and the relevant provisions should be addressed with a different approach, tending to enhance control and to allow easier exits upon (i) offers for a 100% percent of the stock (drag-along provision), or (ii) irreconcilable disputes (auto executable call options).

  Try to agree on an amendment of the target's By-laws so as to reflect therein as many provisions of the SHA as possible. Insertion of the relevant provisions in the By-laws will make them enforceable vis-à-vis third parties.

- <u>An alternative in case you are not confident enough, but wish to invest anyway: you may skip equity</u>. Some funds are forgoing control and investing in mezzanine debt rather than in equity. This kind of investment provides attractive risk-return ratios, and allows pre-defined exit upon loan amortization, or even conversion into equity upon certain conditions. It may also be combined with options for equity-debt SWAPS. In Argentina this figure is currently facing certain regulatory restrictions, but upon adequate structuring it may be used within the applicable legal framework.

- <u>When negotiating the Stock Purchase Agreement ("SPA"), make sure to demand extensive and detailed reps & wars from the selling party</u>. You will probably find that generics are easier to ignore, even in good faith, than specifics, and as you move along demanding reps & wars on specific items, the seller shall be likely to feel the pressure and perform its own due-diligence, disclosing new data upon discussions arising from denial to represent certain facts. Such *de-facto* extra due-diligence might trigger adjustments in the negotiation of the purchase price, depending on its results. Make sure the SPA is structured in a way that breaches to the reps & wars are adequately linked to indemnification provisions. Remember to agree a survival of the indemnification provisions for certain time after the closing date, preferably linking such survival to the statutes of termination for each specific claim.

  In the event the deal is structured upon a capital increase through a subscription agreement with the target company, make sure the reps & wars are made also by the controlling shareholders.

- <u>Do not rely entirely upon sheer indemnification provisions: make sure they are enforceable in reasonable time, bearing in mind that it would not be convenient to have to resort to court or arbitrators</u>. Make sure the purchase price is not entirely paid-in at the closing date, so that any purchase price outstanding balance may be set-off against indemnification obligations. Otherwise, demand that a stake of the purchase price (10 to 25%) is left in escrow for a reasonable period (typically 2 or 3 years, and with release in installments) with a foreign financial institution, as a guarantee to the indemnification obligation. Pledges of the selling party's unsold shares are also used, and advisable for many reasons, but such a guarantee may result in a poor remedy in case the company's liabilities impact on the stock value.

- <u>Make sure to demand insertion of adequate non-compete provisions within the SPA</u>. Even though enforcement thereof may prove to be troublesome, the state-of-the-art boiler-plate provision is recommended, particularly when the selling shareholders persona is of the essence to success in the relevant line of business, either due to their reputation, their contacts, their knowledge or other reasons.

- <u>Keep involved in the management and enforce good corporate governance practices</u>. Private equity investors often pay attention to governance at the outset of an investment and pay sheer lip service to it soon after the closing date. Make sure to choose the right management structure and incentives, and to recruit talented managers and HR capital to blend-in with the company's HR structure: try not to dismantle any successful teams at the outset, since those were the core that added value to the company.

  In case you are planning to substitute management, do not do it right after the closing of the transaction unless there is very good reason. Former management knows a lot about the company and will probably be able to provide you with invaluable insight during the first months. It is true that their loyalties may remain with the selling party, but you can always keep them under adequate surveillance and learn from them until you feel ready to replace them. This paragraph also applies to the company's legal counsel and auditors. Try to avoid hurting feelings in the process, since in the future you may need to resort to former managers, counsel and auditors for relevant information.

- Exit Strategies: Exiting through an IPO is possible but not very likely to happen. Make sure you maintain your contractual exit options at all times. Search for strategic buyers and other funds that may be interested. Keep analyzing exit alternatives at all times.

Political risks, currency devaluations, economic instability and inflation are likely to continue. But also is the growth of the Argentine economy, providing high-profit opportunities to those investors who can detect sectors and companies needing the right financial structure and management to grow at solid rates.

New private equity investors in Argentina should plan their exit before investing, make sure the investment is supported with the adequate legal structure, mitigate their risk through control or through adequate rights, and keep adequate surveillance on management and governance practices.