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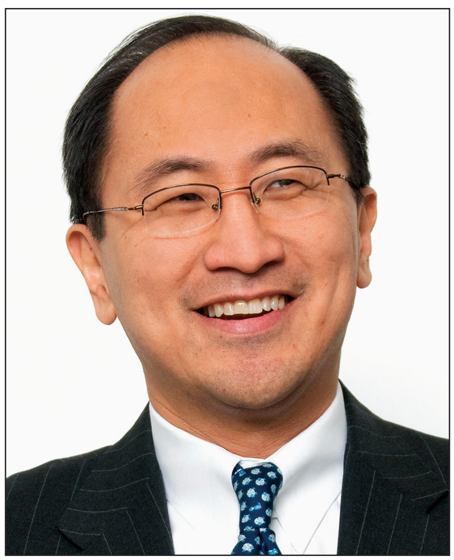
Charting the Global Landscape

Peter Yu discusses the impact of the credit crisis across Europe, Asia and Latin America, and details how Cartesian mitigates risk

Ken MacFadyen

Peter Yu's career path into private equity didn't follow a traditional route. He never spent time as a consultant and didn't put in long hours as a junior banker. Before heading to Wall Street, he spent a good portion of his early career in Washington, notably as a law clerk under outgoing Supreme Court Justice John Paul Stevens and then later, during the Clinton administration, as director to the National Economic Council, the White House office that develops and coordinates economic policy.

It's this background in diplomacy and compromise that prepared Yu for the challenges of buying companies and investing in emerging markets. He is not a proponent, for example, of seeking control as a way to mitigate risks. Rather, he takes the opposite tack, using minority-stake deals to align interests. This kind of "soft power" approach would make most PE investors bristle, especially in countries where the rule of law may not be consistent or entirely clear.



Peter Yu

Yu launched Cartesian Capital in 2006, after roughly 10 years building AIG's in-house private equity practice, AIG Capital Partners. The firm, like Yu's predecessor, invests in areas such as Latin America, Central and Eastern Europe and Asia. The strategy Yu outlines is one focused on identifying dislocations amid longer term growth trends, which he calls 'continuities.'

While the international landscape continues to shift, thanks to the prolonged sovereign debt crisis emanating out of Greece and Spain, Yu remains confident that globalization will press on. He is not, however, under the belief that there won't be future issues along the way. Yu spoke with *Mergers & Acquisitions* in May about his take on the state of the global market. The following is an edited version of that conversation.

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Mergers & Acquisitions: *In the past you've talked about Cartesian's strategy of targeting dislocations and continuities, defined as broad, long-term trends fueled by underlying changes to things like a country's demographics, politics, or technology. Given what is going on worldwide, it seems like the 'dislocation' piece is abundant, but it must be harder to find continuities you can trust.*

Yu: It's important to distinguish between a dislocation and a plain old devaluation. A dislocation is a gap between price and value. To find that, you have to be pretty comfortable about the value of an asset. For the first six to nine months following Lehman's fall, there was so much uncertainty in the world economy, to claim that you had a sense of value would have been presumptuous.

With that said, we've been most active in financial services. It's an area where we feel we can identify an established value. Relatively few markets have well managed central banking systems. But in those that do, economic fundamentals have proven resilient. Because of that we've been able to get comfortable with the idea that we're seeing true dislocations between price and value.

One of our strategies too, is to look for distressed sellers, who might be holding quality assets, but they're motivated to sell them due to corporate or political objectives. In the past, we've acquired assets from WorldCom, Royal Ahold, Amaranth, and more recently, Citigroup.

In these cases, when price becomes a secondary consideration, the dislocation is not necessarily a macro-driven event.

Mergers & Acquisitions: *Have you looked at any of AIG's assets?*

Yu: We looked at some of the assets, but most of what AIG is selling is of the scale that makes more sense for strategic buyers. Also, we won't participate in competitive situations. We never take proposals from investment bankers. Private equity is about finding market inefficiencies, so every deal we've pursued comes from something we've created.

Mergers & Acquisitions: *What might be a recent example of the things you're pursuing?*

Yu: A year ago, we spent a lot of time looking at companies that we thought would be the survivors in the next generation of financial services. We were looking at things like credit cards in China, mortgage lenders in the Ukraine, and ultimately found a mid-market commercial bank in Brazil. At the time, in October, 2008, the financial services sector was going through a very dark period, but we were attracted to Brazil because it has a well managed central bank.

Banco Daycoval is controlled by the family of Moshe Dayan. During the financial crisis, the bank needed to raise long-term private capital at a time when the only people investing in banks were the governments. The assets, historically, showed a return on equity of 15% and had a cap ratio of 20 percent. Our investment took the form of a five-year certificate of deposit, which carries a 15% interest rate. We also secured warrants for common and preferred shares exercisable at a price equivalent to the company's 2008 book value. The deal has the equity upside of a traditional investment, but the downside of a CD. It goes back to our strategy of trying find long-term value, while structuring our investments to manage the risks.

Mergers & Acquisitions: *Being an emerging market investor that primarily makes growth capital plays seems like a strategy that comes with a lot of risk in a normal market. How do you manage that in an environment like today?*

Yu: We almost exclusively target minority-stake investments. Like the Daycoval deal, what we'll do is try to buy new shares in companies as opposed to old shares, and our goal is to help bring a business to a level that creates higher multiples for everyone involved. We're specifically looking for businesses that are market leaders in their home jurisdictions and we'll work to turn them into international market leaders. They may not have the highest level of transparency or corporate governance. Our goal is to instill a culture of corporate governance and position a company globally.

Mergers & Acquisitions: *How do you mitigate the risks around rule of law in emerging markets? We've seen so many deals, successful transactions, undone by regulators who want foreign investment but have misgivings once the investors start realizing profits.*

Yu: You never don't worry about that. The fundamental question underlying every one of our investments is how to manage risk in lower transparency environments, where there is either a shorter history of rule of law or different legal institutions that you have to understand.

Without casting aspersions, the typical response in private equity is to seek out more control as a way to mitigate risk. But that doesn't necessarily solve the particular challenges you may find in emerging markets, where there is less certainty around enforceability or just a lower quality of corporate governance. The right answer to that isn't to buy more of an asset. Our approach is to understand the risks and then develop a deep amount of trust with the groups we're backing. Then we will exercise a 'soft' power to try to instill change. It takes an extraordinary amount of time.

In the end, you won't be able to enforce anything against a local regime without destroying your reputation. So the ability to persuade, rather than sell, tends to be more important for us.

Mergers & Acquisitions: *What are some of your thoughts on Europe? Does the Euro's fall create an opportunity or rather does that reflect some fundamental problems that point to cracks in the European Union?*

Yu: There is an underlying structural weakness to the European Union. It creates an interesting political dynamic though, because you have such disparate economies. On one hand, it's in everyone's best interest that the Euro survives, but at the same time, they also benefit from a weak Euro. Tactically, the EU members need to show enough support to ensure the former, but create enough doubt to secure the latter. It's a fine line to walk. It also requires around two dozen politicians to act rationally, and the chance that happens is pretty low.

Mergers & Acquisitions: *And what effect does this have on the region's appeal to investors?*

Yu: For us, what is concerning is really the underlying demographics. Europe has an aging population base that, depending on the country, is either slowly growing or shrinking. There are very high social costs in the region, and there will be relatively high fiscal deficits for at least the next ten to 15 years. It's hard to see Europe serving as a sustained source for global economic growth.

Mergers & Acquisitions: *How would that differ from the US?*

Yu: Culturally, there is a long track record of re-invention domestically. The US is essentially a 'don't count me out' economy. Also, the magnitude of the US market means that it is unavoidable. For our investments in emerging markets, the US is such a large part of the equation, that you can't ignore it.

The US dollar is also the reserve currency of choice, so despite the fiscal problems we face, that's what really keeps the economy afloat. When the day comes when there is another reserve currency out there, you have to wonder what that will mean, both economically and psychologically.

Mergers & Acquisitions: *That of course leads us to Asia.*

Yu: All signs point to Asia as continuing to be an important component to the world's economic growth for the next 25 years. In terms of the demographics, in terms of productivity, Asia clearly is going to remain a key part to the world economy.

However, I think the bigger question revolves around Asia's appeal as an investment destination. This one is more difficult to answer.

When you think about China, for instance, it's important to understand that the Chinese government has been masterful in controlling access. The Central Government knows that the rest of the world economy now needs China. So they can dole out access very deliberately, as needed. People don't like to hear this, but in some ways large portions of the Chinese economy are only going be for the Chinese; it's the same way large portions of the Russian economy are only accessible to Russians. Multinational investors will never get the same access. People talk about the grand promise of China, but you have to ask, what kind of investment opportunity does that provide and for whom?

Mergers & Acquisitions: *The recent tinkering to the laws governing foreign investors seems to underscore the idea that China is very deliberate in how it doles out access.*

Yu: On one hand it shows signs of openness and on the other is highly conditional and well controlled; it's exactly how you would expect China to do it.

They've also been very tentative as it relates to the amount of outbound investments they'll allow from Chinese locals. What that means is that there is a lot of capital trapped in China. That is good for political reasons, but while it fuels domestic investment, it also helps fuel asset bubbles. I think the recent efforts by the Central Government reflects their need to control the economy and manage it in a way that keeps expectations reasonable.

Mergers & Acquisitions: *You've also done a lot in Latin America, such as the bank deal you mentioned earlier. What's driving activity in the region? Brazil, in particular, is generating a lot of interest from private equity.*

Yu: A lot of the fundamentals are the same as Asia. Whether you're talking about a middle class family in São Paulo or Shanghai, the needs are the same, so areas like education and healthcare are attractive segments if you want to invest behind those emerging middle-class populations. But the differences are as significant as the similarities.

Brazil, for instance, is building close ties to Asia and China in particular, which is a fit considering the country's natural resources. Brazil's scale and presence allow the country to be a certain kind of partner with China. The other emerging countries, such as Chile, Argentina, Columbia and Mexico, however, need to build different relationships with different levels of dependency. I think that speaks to some of the volatility in other countries in Latin America.

The next five years, I think, will be a great time to watch Brazil shake off that last group of critics who have been worried that every political transition brings with it an economic disruption. I'm personally an optimist.

Mergers & Acquisitions: *The BRICs still seem to get all the attention, except for perhaps Russia. Are there other emerging markets that you find intriguing as Brazil, India and China all mature?*

Yu: We tend to let others take on the frontier markets. For us the BRICs serve as anchors to what we do.

If I had to guess which markets in the next tier are the most attractive, I think Turkey has an extraordinary position in the world, both economically and politically. The country has reasonably priced labor, both for Europe and Asia, and also has the beginnings of a very significant consumer class. Politically, Turkey is positioned at the intersection of the Middle East, Asia and Europe. It's symbolically a very important position, and I think we'll see the country play a more significant role going forward. M&A