FUNDfire
A Financial Times Service

Print | Close Window

Cuba Emerges as Unique Private Equity Target

By Tom Stabile August 31, 2016

The thawing of relations between the United States and Cuba that picked up speed in 2015, with the two nations re-opening embassies after 54 years, has already led a few private equity professionals to scout the market for portfolio companies. But experts on investing in the region say the market offers a daunting mix: enticing investments and strong foundations in education, healthcare, and infrastructure alongside a government-controlled economy and virtually non-existent financial sector.

Many key variables in Cuba's potential economic emergence are still unclear, including the likely the biggest – the ongoing U.S. embargo of the island nation's markets, which remains in place due to a political stalemate on the issue in Washington. But even without the floodgates that would open with a lifting of the embargo, private equity pros say there are avenues for foreign investment to provide the nascent Cuban business community – largely made up of smaller private enterprises that are part-owned by the state – to meet pent-up demand in the developing economy.

"There's going to be a need for large foreign investment in Cuba to support growth," says **Michael Andrews**, co-managing partner and CIO of **Cuba Avanza Partners**, a private equity firm targeting small and medium-sized businesses in Cuba that will also use a sustainable investing approach. "As regulations continue to change and the embargo is lifted, you'll see ongoing investment."

While Andrews's firm is targeting Cuba exclusively, others are also aiming at the market with broader regional private equity funds, including **Thomas J. Herzfeld Advisors**, a Miami-based fund manager that already runs a "Caribbean Basin" mutual fund heavily tilted to Cuba.

Private equity shops aiming at the Caribbean are not common, with most Latin America-oriented funds investing in bigger markets such as Brazil, Mexico, Colombia, Peru, and Argentina, says **Luke Moderhack**, senior research analyst at **EMPEA**, formerly known as the Emerging Markets Private Equity Association. Only a handful of private equity funds have gone into the Caribbean region, he says.

"There have been only three in the last two years," he says.

And none were active in Cuba in recent years, says **Jeff Schlapinski**, director of research at EMPEA.

"That's not a surprise given the state of the economy and rules in place for foreign investment," he adds. "In the regional context, it's a larger market and well-educated, but private equity firms need to see investable companies."

The Latin American region overall has seen fundraising taper off in the past two years, from a $10 billion high in 2014 down to $2.7 billion last year and $1.3 billion so far this year through June 30. But Cuba's investing prospects may be more aligned with other once-closed economies than with its region for now – nations such as Vietnam and Myanmar that have transitioned to accepting foreign investment, Schlapinski says.

"We've seen Myanmar slowly go through the process over the last half dozen years, and we're finally seeing fund managers dedicated to the nation," he says. "It's not the timeframe so much as the process of the government taking regulatory and legislative steps and establishing new institutions for markets to become more attractive for foreign investment."

The Cuban market has natural advantages for future investment prospects, even if optimism in some cases is ahead of a "relative warming of relations" stemming from the embassy openings and the start of commercial flights with restrictions, says **Eric Wheeler**, senior associate at **Risk Advisory Group**, a political affairs analyst and consultant.

"It has all of the features of an attractive investment destination," he says, citing the best-educated populace in the region, relatively well-developed road and farming infrastructure, and a highly respected healthcare sector. "These features make it relatively easy to navigate, and of course it's also not far from the U.S."

Cuba already has a growing real estate and tourism industry that is primed for foreign capital, but beyond that are opportunities to invest in construction, port infrastructure, nickel mining, and renewable energy, Wheeler says.

Many of the opportunities in the near term are in businesses that can help the Cuban economy itself grow, Andrews says. That starts with energy generation, which can include wind and solar industry firms, as well as investments in firms to upgrade roadways and communications networks, he says. From there, more opportunities may arise to invest in the tourism sector, as well as agriculture, restaurant, and food businesses.

"Then as you see a middle class beginning to grow and disposable income beginning to rise, there will be an increase in imports and domestic consumption," Andrews says.

Unlike other fund managers that mainly plan to invest in U.S. companies that will benefit from Cuba's economic changes, Andrews says his firm's goal is to invest in companies physically located on the island that can create jobs and grow the economy further.

Still, challenges abound for any investors looking at Cuba today, with the lingering embargo among the largest obstacles, Wheeler says. U.S. companies don't have much "wiggle room" to do business while the embargo stands, he says.

"Having it lift in a couple of years is best case scenario," he says.

There are creative ways around the current restrictions, with some instances of U.S. investors getting federal government approval for specific deals, such as a small factory to sell tractors to Cuban farmers, Wheeler says. "There are different ways of structuring [deals] that have worked for others," he says.

Another hurdle is Cuba's very limited financial sector, which has no stock market, significant government involvement in private enterprises, and a currency that can only be exchanged in the country, Wheeler says.

"The framework is not as developed," he says.

But the Cuban government has shown signs of willingness to invite foreign capital with less restrictive terms, including a new trade zone created last year and a new investment law passed in 2014. "There is some reason to think the Cuban government may relax restrictions further at some point," Wheeler says.

Corruption and bribery are also concerns in any transitioning market, especially coming from a model of heavy state control. But there are steps fund managers can take to mitigate such risk even in these new markets, Schlapinski says.

"Having a local network is extremely important – knowing which businesses or individuals to avoid," he says. "Another factor is choice of sector – avoiding industries connected to the government or politically exposed individuals."