WHU

Wissenschaftliche Hochschule für Unternehmensführung

- Otto Beisheim Graduate School of Management -

Venture Capital in South America

Unlocking the Potential for Venture Creation in an Emerging Market

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Background of Study

This study was prepared by Matthias Baltin and Philipp Bell as a Diploma Thesis for the WHU – Otto Beisheim Graduate School of Management – near Koblenz, Germany. Founded in 1984, the WHU is a private, state-accredited business school of university ranking with a network of over 100 partner-universities all over the world. More information can be found in the Internet at http://www.whu.edu.

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Abbreviations

ABCR	Associação Brasileira de Capital de Risco (Brazilian Venture Capital Association)
ADR	American Depository Receipt
AFP	Administradoras de Fondos de Pensiones (Pension Fund Administrator)
Anprotec	Associação Nacional de Entidades Promotoras de Empreendimentos de Tecnologias Avançadas (Association of Brazilian Incubators)
B2B	Business-to-Business
B2C	Business-to-Consumer
BNDE	Banco Nacional do Desenvolvimento Econômico (Brazilian Development Bank)
BNDESPAR	Banco Nacional do Desenvolvimento Econômico Participação (Participation Branch of the Brazilian Development Bank)
BOVESPA	Bolsa de Valores de São Paulo (São Paulo Stock Exchange)
C2C	Consumer-to-Consumer
CEO	Chief Executive Officer
COO	Chief Operative Officer
CORFO	Corporación de Fomento de la Producción (Production Promotion Agency)
CVM	Comissão de Valores Mobiliários (SEC)
EMBI +	Emerging Markets Bond Index Plus
EU	European Union
EVCA	European Venture Capital Association
FGV	Fundação Getulio Vargas
FIDE	Fondo de Inversión para el Desarrollo de Empresas (Investment Fund for Venture Capital)
FIEEM	Fundos Mútuos de Investimento em Empresas Emergentes

FII	Fondos de Inversión Immobiliarios (Investment Fund for Real Estate)
FIM	Fondos de Inversión Mobiliarios (Investment Fund for Stocks)
FINEP	Financiadora de Estudos e Projetos
FONCAP	Fondo de Capital Social (Social Capital Fund)
FONTAR	Fondo Tecnológico Argentino (Argentine Technology Fund)
GDP	Gross Domestic Product
IBRASA	Investimentos Brasileiros S/A
IDB	Inter-American Development Bank
IGPM	Índice Geral de Preços de Mercado (General Price Index)
IPO	Initial Public Offering
ISP	Internet Service Provider
LBO	Leveraged Buyout
MBO	Management Buyout
MERCOSUR	Mercado Comun del Sur
MERVAL	El Mercado de Valores de Buenos Aires S.A. (Buenos Aires Stock Exchange)
NAFTA	North American Free Trade Agreement
NASDAQ	National Association of Securities Dealers Automated Quotation
NVCA	National Venture Capital Association
NYSE	New York Stock Exchange
PUC Rio	Pontifica Universidad Catolica de Rio de Janeiro
USP	Universidad de São Paulo

1 Executive Summary

In recent years, the topic of entrepreneurship has gained increased popular attention and formed the subject of numerous studies. At the same time, however, the requirements for wealth creation through entrepreneurship in South America have been studied to a far lower degree than in developed countries. In an entrepreneurial environment suffering from lack of capital, venture capital could become the driver of growth. Therefore, the present study aims to contribute to closing the information gap with a focus on venture capital in Argentina, Brazil and Chile. It builds on 85 personal interviews with experts on risk capital in the three countries, conducted between May and July 2001.

Given the fact that venture capital investments form a long-term commitment the following macroeconomic parameters need to be taken into consideration:

- Country risk ratings are elevated, with a current upward drift caused by an economic crisis in Argentina.
- For the same reason, the Brazilian and Chilean currencies have devaluated in the recent past and the dollar-pegged Argentine Peso is under increased pressure.
- Income is most unequally distributed in Brazil, where one half of the population receives a mere 10% of the total income, while Chile and Argentina show a larger middle class. GDP per capita (PPP) is at US$6,200, US$12,400 and US$ 10,000, respectively.
- Unemployment is at critical levels in Argentina (17%) and Chile (9.6%), while Brazil does well in this regard (6.4%).
- Stock markets throughout the region suffer from a severe lack of liquidity, caused by the lack of protection for minority shareholders, absence of a local shareholder culture, and continuing delistings.
- Argentina and Brazil have suffered from rampant hyperinflation until the beginning of the 1990s, contrary to Chile where inflation was high but not fatal during the 1980s.
- Interest rates are high in Argentina and Brazil, well in excess of 15% thereby adding to the scarcity of capital.
- Foreign direct investments hit a record high in 1999 with more than US$60 billion, which toppled considerably in 2000.
- The MERCOSUR is an important free-market initiative that has the potential to create increased economic dynamism in the region.

In Argentina, Brazil and Chile, venture capital has developed in a similar fashion. Four phases can be distinguished:

1. Privatization (1980 – 1994): Governmental privatization programs throughout the region opened buyout opportunities to private investors, which were first tapped by local financial institutions and industry groups.
2. Private equity (1995 – 1998): Continued privatization in South America and an increased focus on emerging markets from abroad attracted U.S. private equity firms into the region, further proliferating the buyout model. Their overall performance was poor.
3. High-tech Frenzy (1999 – 5/2000): The dispersion of Internet technology throughout South America spurred entrepreneurs' and investors' activity, triggering a dreamful flight from fundamentals. The first serious cases of venture capital can be observed.
4. Restructuring (6/2000 – 2001): As most capital sources have dried up, investors tidied up their portfolios. The market has seen a healthy purification, marked by the survival of sound startups and the entrance of highly skilled venture capital investors.

The current situation is characterized by careful investing in solid business opportunities, while the new class of venture capital investors gains a foothold in the market. Many private equity investors have retreated to larger investment segments after a brief stint in the early stage arena. Only few investors have conducted exits, almost all of which were strategic sales. Despite several good auspices, it seems that ultimately the viability of risk capital investments in South America remains to be proven.

The study continues with an individual assessment of the situation of venture capital in each of the three countries. Findings that hold true for all countries include the existence of numerous business opportunities, which is countered by the difficulty to exit from investments. On a country-level, the following results are most noteworthy:

Argentina: Despite zero government support, Argentina has seen the highest number of startups in the past three years. Currently, the country is stifled by a severe economic crisis, which does not seem to grant a fast recovery. Notwithstanding, a set of serious venture capitalists plan to exploit medium- to long-term opportunities arising from a high per-capita GDP, sound education and the country's entrepreneurial potential.

To improve the situation for venture capital in the country, Argentina has to attack its deficit problem and provide a clear long-term political strategy. Fighting the US$25 billion tax evasion and adapting the tax system to the needs of startups should go hand in hand with an effort to join the Brazilian BOVESPA initiative to create a liquid stock market.

Brazil: This country creates dynamism through the sheer size of its domestic market, thereby attracting many foreign investors. An array of government initiatives and a strong private equity sector support Brazilian entrepreneurs. On the other hand, macroeconomic instability, intricate regulation and relatively poor management education pose difficulties for the developing venture capital sector.

Implementing policies to bring down interest rates and a significant simplification of the tax system should be next on Brazil's agenda. A success of the Novo Mercado initiative is crucial, while the Brazilian Venture Capital Association must increase its influence to close the gap for innovation capital and spread efforts on the education level.

Chile: By far the smallest of the three countries studied, Chile struggles to create awareness among international investors. It has to offer the soundest macroeconomic conditions, an effective government program (CORFO), and strong institutional investors through a powerful pension fund system. Besides geographic remoteness from large markets, venture creation in this country is faced with a culture that is little entrepreneurial.

Chile's homework should include a changed incentive structure for pension fund investments to foster diversification. Capital gains tax and insufficient minority shareholder protection have to be taken care of. The private sector must be reactivated to assure a market oriented growth path of the venture capital industry.

On the basis of these findings, a possible model for venture capital in South America is developed, responding to the idiosyncrasies of the region's market. It is based on the assumption that stock markets will remain illiquid in the short- to medium term; hence, pure financial returns will not drive additional capital inflow.

Given the need for additional strategic incentives to investors, the model intends to dedicate a venture capital fund to a certain industry or sector while raising the capital from limited partners with a strategic interest in the respective area. The strategic mindset required from such investors opens an opportunity for European investors to engage stronger in the region. Furthermore, the fund's segment focus will call for a regional scope to increase deal-flow, coupled with a local presence to respond to manifold cultural and regulatory differences in the countries. Another necessary condition of a successful venture capital model in South America is strong involvement in the portfolio companies to compensate for the entrepreneurs' lack of experience or education.

With the proposed structure, strategic (European) limited partners provide access to capital and industry knowledge while gaining a local presence, effectively outsourcing R&D efforts. The South American fund provides venture capital knowledge and local access to networks while establishing strategic partnerships and a potential exit opportunity for its portfolio companies. The structure could be strengthened further by cooperation with local industry groups.

After the three years since its inception in the region, South American venture capital finally seems to get serious. At this point, it can almost only get better for this young sector. Whether one is only mildly optimistic or enthusiastic about the long-term viability of this model in South America, the potential is huge: Proliferation of the venture creation process can make the region comply with a promise it has persistently made during many past decades: That it is - finally - the continent of the future!

Side-note:

This study is targeted also towards readers who are unfamiliar with the South American economies. Therefore, the macroeconomic environment and the history of venture capital is covered in detail to provide an overview.

For readers already familiar with the topic and the region we recommend to focus on the challenges and chances and the outlook section for each country. Furthermore we would like to draw the attention to the developed venture capital model.

2 Introduction

2.1 Motivation

The second half of the 1990s has seen a strong increase in the number of foundations of technology companies in the U.S., soon followed by Europe, Japan and other economies. This phenomenon has drawn wide public interest to the area of entrepreneurship. While this wave of venture creation, its foundations, development and effects on societies has been the subject of multiple studies in the developed countries, the situation of entrepreneurship in the emerging South American markets is only known to a much lesser extent.

For decades, many international companies have viewed South America as an enormous future market. Throughout all these years, however, this opinion has persistently remained a mere future vision. Most South American markets have been liberalized and opened to international investments only ten years ago. The current situation is still characterized by inefficiencies, bureaucratic procedures and the existence of oligopolistic structures. Apart from these problems, many South American economies have been battered by severe macroeconomic crisis during the last decade, which in some cases still subsists today.

In this context, new venture creation could be <u>the</u> driver of future economic growth and increasing wealth in these countries. South American entrepreneurs can build on the vast opportunities for restructuring and efficiency gains through technological innovation, thereby accelerating economic growth and decreasing unemployment.

The fuel for this engine of venture creation is capital. Where market opportunities, entrepreneurial spirit and business education are in place, capital will trigger the foundation of new companies. But capital for young companies is currently the critical factor in South America. Throughout most of the continent, personal wealth is neither high enough nor sufficiently dispersed to support strong venture creation. Additionally, interest rates are too high to make debt financing a viable option, while liquidity-starved stock markets show no interest to accommodate young companies. These circumstances raise the importance of venture capital to unleash a potential process of wealth creation in South America.

Presently, a venture capital sector is developing in South America. After this sector has seen a phase of rapid growth through investment frenzy in Internet businesses two years ago, its development has currently slowed down considerably as a consequence of the NASDAQ correction last year. As the venture capital community in South America is now in a state of re-orientation, this moment is particularly suitable for a study on the venture capital sector's history and possible future development.

In the light of unique South American idiosyncrasies, this evolving venture capital sector can be expected to differ considerably from corresponding sectors in the U.S. or Europe. The study of these characteristics will provide insight on how a wealth creation process in South America may be initiated. In particular, this divergence will be caused by parameters such as the macroeconomic situation with exuberant interest rates, a volatile political environment, low GDP per capita, and unpredictable exchange rates. Moreover, as already hinted at above, Latin American stock markets are largely undercapitalized, and have not offered a fertile ground for exits from venture capital investments.

The motivation of this study is to educate the reader on the importance of venture capital for the South American economies, to provide an insight into the unique characteristics of this market, particularly to individuals of the investment community considering to conduct business in this region, and to develop a possible model for the South American venture capital environment.

2.2 Procedure

2.2.1 Definitions

2.2.1.1 Private Equity, Venture Capital and Risk Capital

By private equity and venture capital, we refer to the "formalized process of financial intermediation, whereby a general partner raises funds from limited partners, normally institutional or high-net-worth investors, and then selectively invests these funds in portfolio companies in which the general partner takes an active advisory and/or management role"[1].

[1] Latin American Private Equity Review & Outlook 2000/2001, p. 9

In South America, both private equity and venture capital are still very young and the exact definition is not always known or used in the local language. Investors and government organizations alike mostly refer to both investment categories as “capital de risco / capital de riesgo”. The important distinction between the two categories is normally seen in the type of investments made. Whereas private equity investing takes place in a later stage and in traditional industries with proven business models and technology, venture capital is employed at an earlier stage under more uncertainty about technological development.

Both venture capital and private equity investors provide more than simply capital to their portfolio companies and are frequently involved in strategic counseling or even participating in operational activity of their portfolio companies. To venture capital investors, however, this generally applies to a larger extent than to private equity investors.

When talking about risk capital, we adopt the South American understanding and refer to private equity and venture capital jointly.

2.2.1.2 South America vs. Latin America

Latin America includes all countries of the western hemisphere south of the U.S., thereby including the Central American isthmus. In contrast to that, South America refers to the continent between Cape Horn and Colombia, excluding all countries to the north of the Darien gap between Colombia and Panama.

2.2.2 Scope and Limitations

The scope of this study is the venture capital sector in South America.

In terms of investment categories, however, the scope has been broadened: This study also touches on love money, angel investments, private equity (including pure private equity, corporate private equity and allocations to private equity from within a major financial institution), as well as incubators, both private and university-related. The reason for this extension lies in the fact that the development of these investment types has important effects on the venture capital sector.

In terms of regional scope, on the other hand, this study is subject to increased focus: It will only analyze the situations in Argentina, Brazil and Chile. Combined, these three countries account for 60% of total GDP in South America and are responsible for more than 80% of new venture creation in the region during the last three years. Accordingly, they have received the greatest portion of private equity and venture capital in South America, and can be expected to lead the way for the remainder of the continent.[2] They are therefore the most important South American countries with regard to the subject of this study.

2.2.3 Structure

After a brief introduction, the study will start with an in-depth assessment of the macroeconomic conditions in the three countries. The study of this greater setting is necessary in order to understand the unique characteristics in the development of venture capital in South American. Consequently, the macroeconomic assessment will play an important role in the development of the Latin-style venture capital model, as discussed towards the end of the study.

After studying the macroeconomic situation in the respective countries, the report will provide an overview of the history of venture capital in the region. The development of this asset class can be split into four distinctive phases, which were similar in each country. In this chapter, the key influencing factors for the development of venture capital in each phase will be discussed, before they are contrasted to the development of such sector in the U.S. and Europe.

Although the four-phase history of the venture capital sector and several characteristics of the current situation are similar in Argentina, Brazil and Chile, the specific forces behind the development in each country differ considerably. Therefore, each country will be assessed separately in the ensuing chapter, which aims at providing a detailed overview of the respective country, including existing challenges and chances for future development. This part of the study will include specific suggestions to improve the framework for venture capital in the respective country.

Drawing on the lessons learned from the assessment of venture capital in the different countries, Chapter 5 will then draft a new model for Latin-style venture capital. Taking into account the differences in the environment, the model identifies key prerequisites for building a healthy venture capital structure in the region and describes a framework for a potential model that could overcome many of the obstacles the sector is still facing today.

[2] McDermott (2000), p. 10

The last chapter will conclude the study and give indications on possible areas for further research.

2.2.4 Methodology

The main part of this study is based on 85 interviews with experts on the topic of venture capital and entrepreneurship in South America. 79 of these interviews have been conducted face-to-face between May 28 and July 25, 2001 in Buenos Aires (Argentina), São Paulo and Rio de Janeiro (Brazil), as well as in Santiago and Viña del Mar (Chile). Six interviews were conducted by telephone with experts in Argentina, Brazil, Chile and the U.S.

The interviewees can be grouped into three categories. The first category contains investors (Business angels, incubators, venture capital or private equity firms and banks), while the second group encompasses their investment targets, i.e. the startup companies. Here, the sample mainly consists of Internet and high technology companies. The third group comprises experts around the two preceding groups and includes professors, lawyers, consultants, stock market experts, investment bankers, and government organizations. The interviews were structured according to a general framework, which can be found in Appendix A – Interview Agenda.

The nature of this study is mainly descriptive in the regional overview and the individual country discussions. The second part, i.e. the development of a Latin-style venture capital model, will be based on the findings of the first part and therefore derivative by nature. Most of the results of this study cannot be statistically substantiated because of the small size of the venture capital sectors in the studied countries and the absence of exits from investments, which leads to a situation where there is not sufficient data for a statistically relevant analysis. The experience and knowledge of the interviewed experts form an essential source of input for the study.

3 Regional Overview

3.1 Introduction

The following chapter will begin with a regional overview of the historic development and current state of the macroeconomic situation in Argentina, Brazil and Chile. Building on these findings, the history of venture capital in the region will be presented.

A study of venture capital investments in South America needs to begin with a familiarization with the macroeconomic environment. Venture capital activity represents a long-term commitment for the investor, potentially as long as ten years between a limited partner's contribution and the liquidation of the fund. Accordingly, venture capital investors and managers need to adopt a long-term view and monitor closely the macroeconomic conditions and trends of the targeted markets.

The complicated macroeconomic environment in many South American countries underlines the vital nature of such analysis: While in more developed countries, relatively few risks arise from macroeconomic parameters, the instability of the latter in many emerging countries calls for increased attention. In South America, unequal income distribution, a history of inflation, often small domestic markets, soaring interest rates, high unemployment, the existence of oligopolies and volatile exchange rates pose additional problems to the young venture capital sector.

Therefore, chapter 3.2 will present an assessment of the main macroeconomic variables in the three countries that had an important impact on the development of the region's venture capital sector. Chapters 3.3 and 3.4 will then show the history and current situation of this sector, explaining its development on the basis of the macroeconomic situation.

3.2 Assessment of Macroeconomic Environment

3.2.1 Risk Ratings and Interest Rates

Country risk, which is widely used in South America, is generally measured as the spread of the yield on local government bonds over comparative U.S. bonds. This measure indicates the excess return that a country has to pay for the higher risk according to the risk-return principles. Several institutions report the country risk; the most frequently cited source is the JP Morgan EMBI+ indicator.

Figure 1 - Argentina - Country Risk[3]

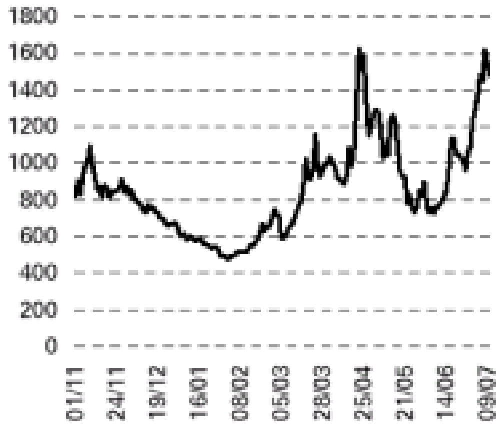

Figure 2 - Brazil - Country Risk

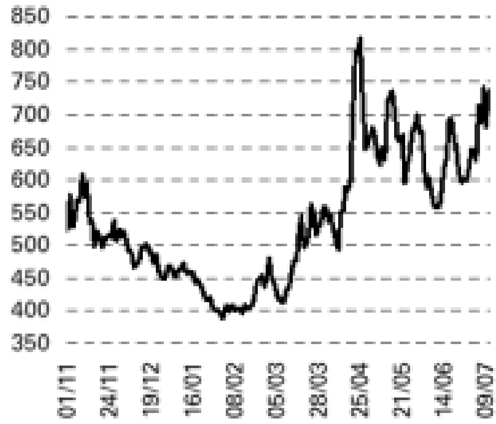

Figure 1 and Figure 2 show the development of the country risk for Argentina and Brazil over the last 8 months, indicating clearly that the South American countries are currently going through times of serious crisis. Both countries are generally classified as very high-risk countries, at risk levels comparable to those of Turkey or Russia, for example.

Chile's economic climate is considerably more stable and secure. Compared to the development in Argentina and Brazil, the country never had to go through a comparable crisis, which reflects in a less entrepreneurial behavior and higher risk aversion of the Chilean people.

Specifically, the country risk has important implications for the refinancing of the government and the whole financial community. Higher country risk implicates that refinancing the deficit spending becomes more expensive.

Argentina and Brazil both have accumulated a large deficit (see Figure 3), which results in big debt-interest payments, and both are still accumulating more debt, although Argentina, because of the imminent default risk, had recently announced a zero-deficit policy for the rest of the year 2001.

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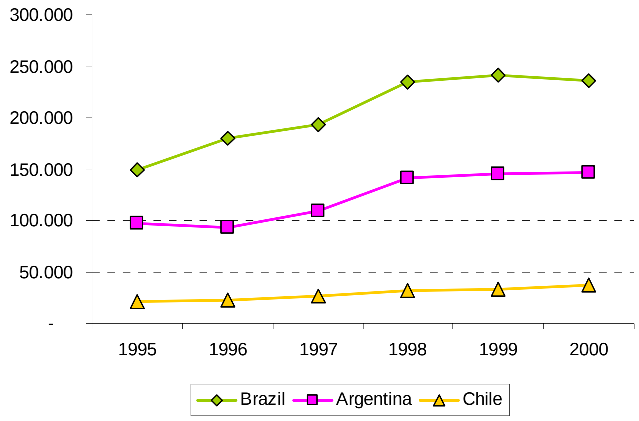
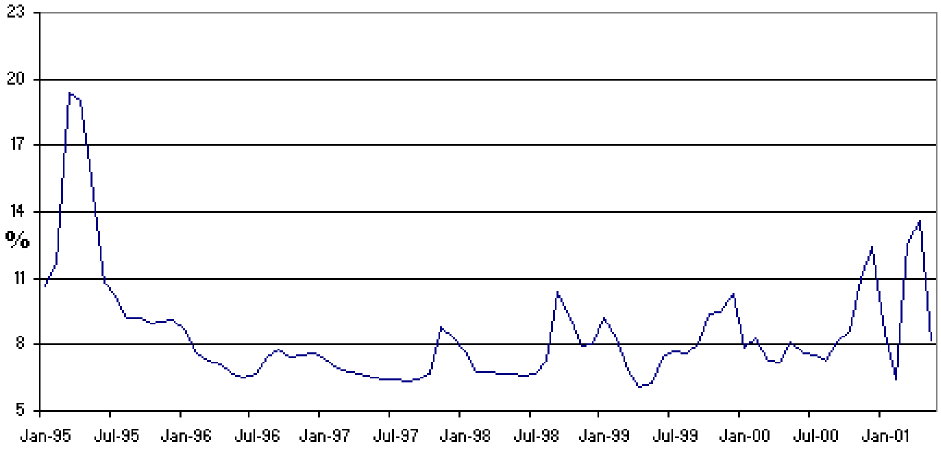
[3] JP Morgan (www.jpmorgan.com)

Figure 3 - External Debt 1995 - 2000[4]



Argentina's debt amounts to 45% of GDP, while the Brazilian debt is already at 57% of GDP. In both cases, the trade balance, negative for Argentina and Chile at 0.8 billion and 1.2 billion respectively[5], does not improve the deficit situation. Consequently, both countries have to refinance an increasing amount of debt by issuing new bonds, which leads to increasing interest rates for all financial instruments. Chile plays again an extra role, as its accumulated debt is only moderate, amounting to 9% of GDP, and interest rates are low compared to its neighbors, easing the pressure on the financial community.

Figure 4 - Argentina - Interest Rates 1995 - 2001[6]



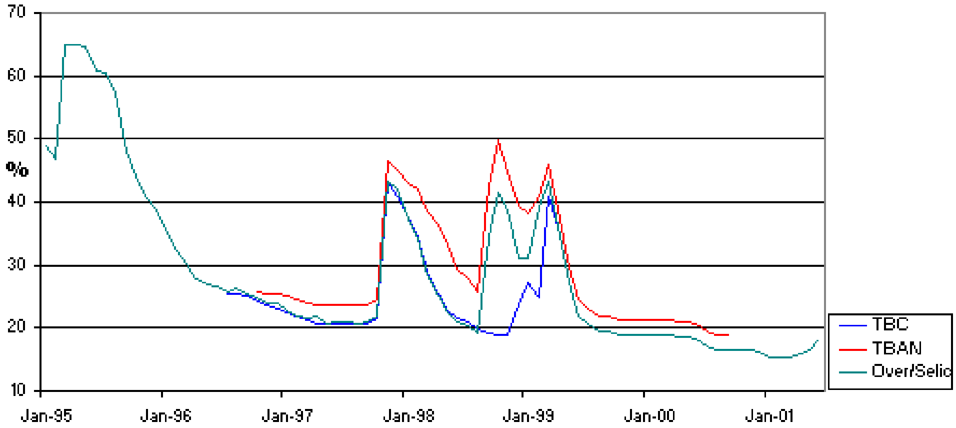
[4] Banco Central de la Republica Argentina, Banco Central do Brasil, Banco Central de Chile

[5] Deutsche Bank Research (www.dbresearch.com)

[6] Source: Banco Central de la Republica Argentina (30-50 day deposits)

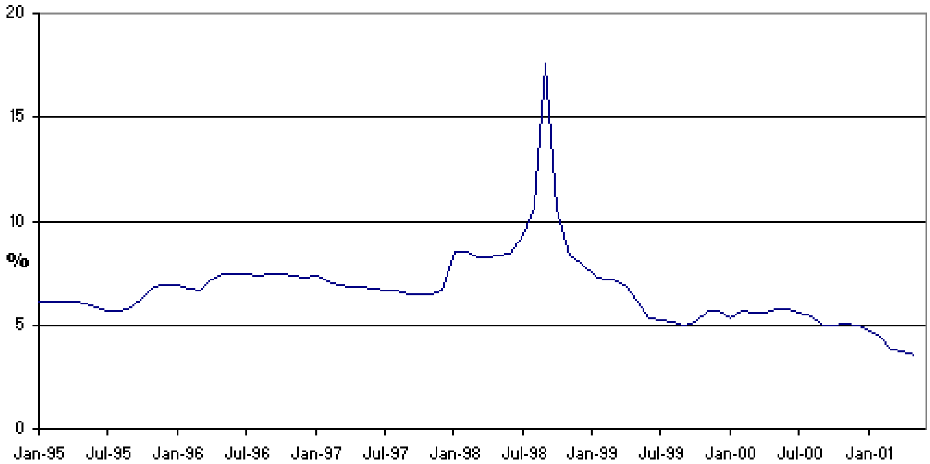
Figures 4 - 6 show the corresponding interest rate levels for short-term financing in Argentina, Brazil and Chile. In 1998, the emerging market crisis in Asia finally reached South America, which lead to a massive outflow of capital from the region and exerted speculative pressure on the exchange rates. To increase the inflow of capital, South American central banks had to raise interest rates significantly.

Figure 5 - Brazil - Interest Rates 1995 - 2001[7]



In Brazil, the high level of interest rates of up to 50%, which only recently dropped slightly under 20%, represents a high barrier to the access to capital. In Chile's history, interest rates of up to 20% were only a temporary phenomenon, while in Argentina the effect was reduced by the dollar-peg, effectively decreasing uncertainty for investors.

Figure 6 - Chile - Interest Rates 1995 - 2001[8]



[7] Banco Central do Brasil

[8] Source: Banco Central de Chile (30 day deposits)

Still, the comparatively high level of interest rates and the continuing demand for capital from the Argentinean and Brazilian governments makes access to capital in the region very difficult. In an effort to finance its debt, the governments were raising interest rates to draw foreign capital into the region, with the result of completely drying up the local markets for debt capital. Big local suppliers of capital such as pension funds, insurance companies and local banks presently hold a major part of their assets in government bonds.

Some multinational companies are still able to refinance on the international capital markets, sometimes even for a significantly lower rate than the governments themselves (which is, in fact, a contradiction), but the access to debt capital for local companies, especially for young startups, is merely impossible.

Missing debt instruments affect companies at every stage of development. Debt capital is not available for starting up a company, in the day-to-day business companies are not able to refinance their working capital and American-style leveraged buyouts are also out of question.

Because access to debt capital is not available for young companies, the provision of long-term equity capital such as venture capital becomes a crucial factor in the development of small and medium-sized companies and thus for the economic development of the region.

It is already notable that startups in South America start smaller and grow slower than their counterparts in Asia. Lack of sufficient funding is one important reason for this. The reliance on financing from suppliers by using the full time-span for payment is also much higher for young South American companies than for Asian startups. These are results from a study on entrepreneurship currently conducted in several South American and Asian countries, which is sponsored by the Inter-American Development Bank.[9]

3.2.2 GDP

Compared to the developed countries in Europe or North America, the South American markets are small. Total GDP in Brazil reached US$529 billion in 1999, while the U.S.

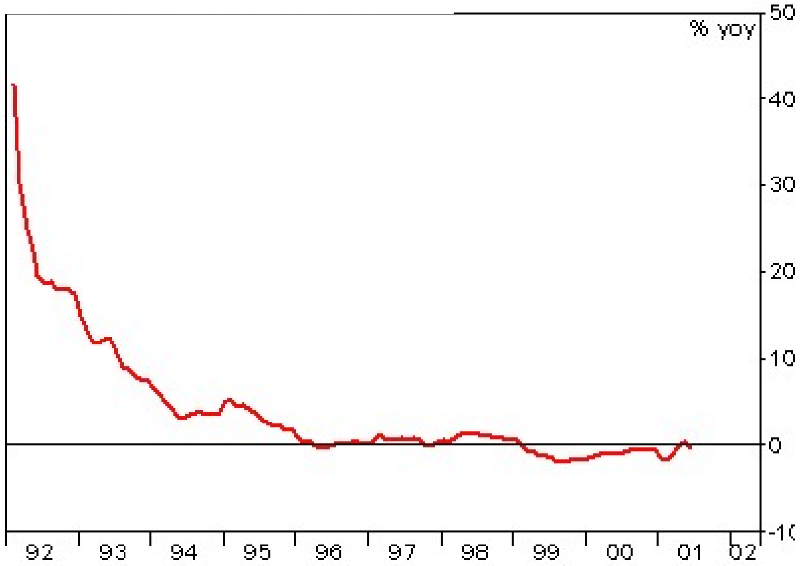
[9] Interview with Hugo Kantis, Coordinator for the “Comparative Study on Entrepreneurship in Latin America and Asia”

realized a GDP of US$9,255 billion in the same year. This vast difference is also reflected in per capita GDP (PPP), which was US$10,000, US$6,200 and US$12,400 in Argentina, Brazil and Chile, respectively. These numbers appear dwindling in comparison to a sum of US$33,800 available to U.S. citizens or US$22,610 for Europeans. Thus, South American markets are smaller because of considerably lower consumption. This fact has to be taken into account when looking at business models in South America.

3.2.3 Inflation

Coming from a period of hyperinflation during the 1980s and early 1990s, both Argentina and Brazil have only recently been able to attract foreign capital to the markets. Currently, all three countries show reasonably low inflation rates, with Argentina, Brazil and Chile at –0.7%, 6.0% and 4.5% in 2000, respectively. The steep development of the inflation rate is epitomized by the extreme example Argentina, which reached an inflation level of zero after adopting the currency board and the dollar-peg.

Figure 7 - Argentina - Consumer Prices[10]



Hyperinflation history has an effect on the behavior of the market participants. Savings are historically low because consumers do not trust long-term vehicles. Additionally, people are not used to long-term planning, which was never fully possible in the past. This lack of long-term vision also reflects in the investment behavior.

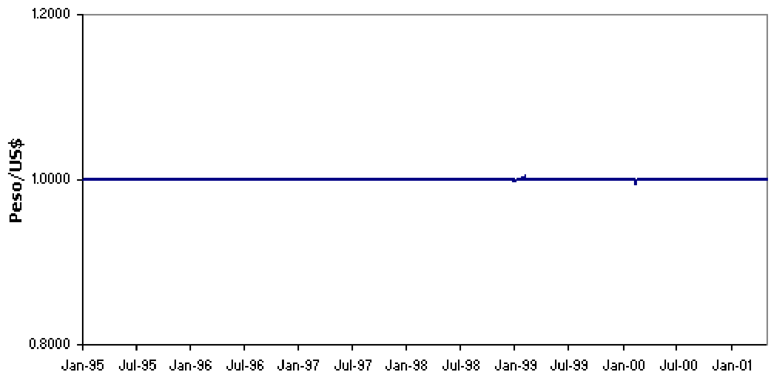
[10] Source: Deutsche Bank Research

3.2.4 Exchange Rate

Exchange rate development is a crucial parameter for returns on investments from abroad. As the capital of most investment funds is denominated in U.S. dollars and investments are made in the local currency with most cash flows also denominated in Pesos or Reals, the effective returns are affected to a great extent by the development of the currency.

Argentina has had a comparative advantage in that regard because in 1991 it had decided to tie its currency one-to-one to the dollar, providing a safe basis for international investments. Currently, speculations on a possible devaluation are as strong as never before, increasing uncertainty to a level that basically defeats all investment proposals.

Figure 8 - Argentina - Exchange Rate Development 1995 - 2001[11]

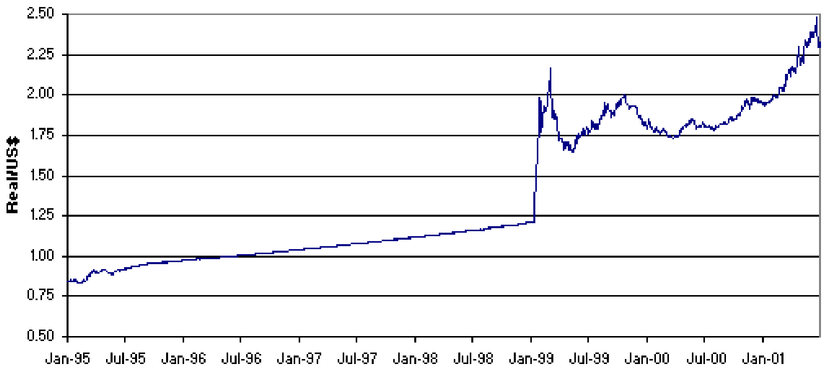


The Brazilian investment community was especially affected by the adverse development of their currency. Until January 1999, the central bank had defined a corridor for the exchange rate but was not able to defend it against speculative attacks in the end. In the following three months, the Real devaluated by about 80%, decreasing returns significantly.

In the wake of an economic crisis in Argentina, the currency has lost again a fourth of its value since January this year and will be affected further if Argentina devaluates the Peso.

[11] Banco Central de la Republica Argentina

Figure 9 - Brazil - Exchange Rate Development 1995 - 2001[12]



Chile has seen a stable development of its currency until mid 1998, when the effects of the Asian crisis caused the start of a devaluation trend, which in different phases and for different reasons continues until today. At the moment, the exchange rate is also strongly influenced by the development in Argentina, much less than by local macroeconomic variables.

Figure 10 - Chile - Exchange Rate Development 1995 - 2001[13]

3.2.5 Trade Integration

South America has seen increased economic dynamism through several efforts towards trade integration. The most prominent of these efforts is the MERCOSUR ('Mercado Comun del Sur'), which was created in 1991 with the signature of the Treaty of Asunción. It forms the common market between Argentina, Brazil, Paraguay and Uruguay, and has been created with the objective to accelerate the economic

[12] Banco Central do Brasil

[13] Source: Banco Central de Chile

development throughout the region. It builds on earlier efforts to unite the South American economies, most directly on the Montevideo Treaty of 1980 that created the Latin American Integration Association. Most participants believe that the MERCOSUR will develop important dynamics during the next three to seven years, growing and integrating the whole of South America into one trading block. In particular, MERCOSUR stands a chance to thwart a Latin American expansion of NAFTA, the North American Free Trade Agreement between Canada, the U.S. and Mexico. NAFTA was implemented in 1994 to promote trade between the participating countries.

Difficulties for the MERCOSUR are likely to arise from the vast legal differences between the individual countries. Additionally, it is important to notice that the differences between the South American economies are not much smaller than differences between European peoples. Despite similarities with regard to language, every country has its own history, culture, and specific attitudes. In this respect, the MERCOSUR can certainly learn from the European Union's effort to find a common denominator in an array of local differences.

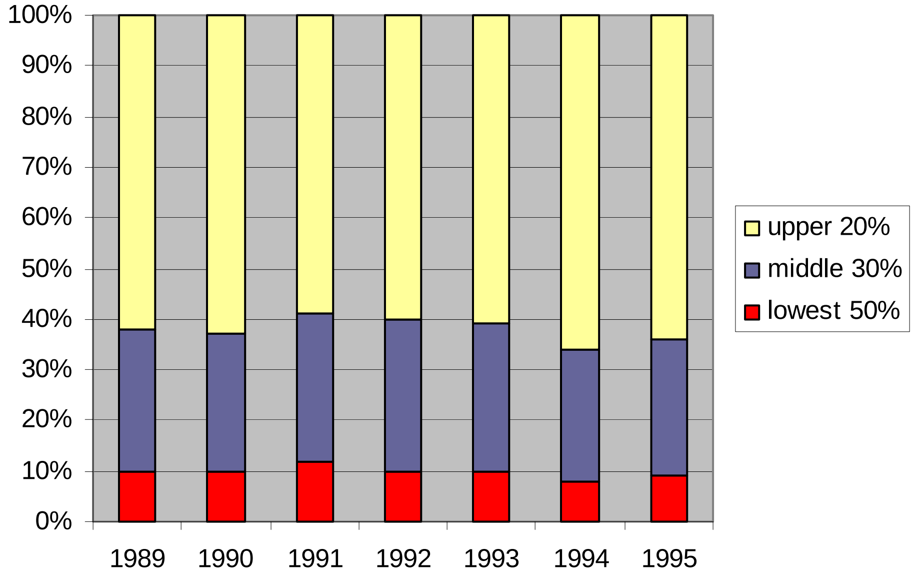
3.2.6 Income Distribution

In terms of consumption, both Argentina and Chile can draw on a substantial group of people with medium income, while Brazil totally lacks a sizable middle class. "Brazil has one of the region's worst income disparities, with an estimated 10% of the population holding more than half the national wealth. In addition, dramatic regional inequities exist between the prosperous south, where most of the nation's manufacturing and value-added services are located, and the poorer northern and central provinces, which still rely on agricultural products and other commodities."[14] Only one third of the Brazilian people is truly participating in the economy with one third in poverty and another third just at the border.

Tapping into the buying power of the region's upper class households remains difficult for companies, because this group has historically been spending much of its income for foreign goods or even abroad. A trip to Miami to buy clothes is still regarded as a symbol of status for the upper class. Additionally, these households also generally spend a smaller percentage of their buying power compared to the middle class.

[14] Latin American Private Equity Review & Outlook 2000/2001, p. 29

Figure 11 - Brazil - Shares of Income of the Richest and Poorest Groups[15]



This lack of a large and prosperous middle-class is also the reason why the application of advertising-based business models is particularly problematic in Brazil.[16]

3.2.7 Stock Markets

As debt financing is not available for most of the South American companies because of high prevailing interest rates, equity remains the only logical source of financing. South American stock markets, however, have been illiquid and highly volatile during the last few years: Many companies were sold to international companies and consequently delisted from the exchange, while other liquid stock was transferred to the NYSE as ADRs, diverting most of the trading volume to the U.S. Examples for delisted companies include YPF and Telefonica in Argentina, which were sold to Spanish companies. ADR listings were completed by Unibanco and most of the companies resulting from the Telebras breakup in Brazil, by Banco de Galicia from Argentina and the telecommunications heavyweight CTC from Chile.

With these developments, liquidity and daily trading volumes are declining considerably. Average daily trading volume in June 2001 on the BOVESPA in Brazil was only R$660 million (approximately US$260 million), down 22% from the previous year. 440 companies made up a total market capitalization of US$194 billion in this month, but only 11 companies accounted for almost half of the total market

[15] Source: Institute of Applied Economic Research (IPEA), (www.ipeadata.com)

[16] Latin American Private Equity Review & Outlook 2000/2001, p. 25

capitalization (US$94 million). In Argentina and Chile the picture is similar, with trading volumes declining on average between 20% and 30% per year for the last four years.[17]

Consequently, most of the foreign portfolio investments on these exchanges were short-term and highly speculative, trying to exploit the high volatility. These investments did actually increase the capitalization of the listed companies temporarily, but did not provide substantial investment capital. The issuance of new equity was out of question for most of the listed firms.

Several "blue-chip" companies were able to access international debt or equity markets to cover their financing needs, but there are only approximately 50 of these firms in each of the covered countries. For many thousand medium-size firms, access to the international markets is not possible and local long-term capital is also not available, as the local stock markets are too weak, corporate bond markets are just evolving and bank credit is extremely expensive.

During the Internet hype, a few venture-backed high technology companies such as StarMedia or ElSitio were able to complete an IPO at the NASDAQ, but shares have been falling ever since the market correction in April 2000, while several other companies that had planned an IPO have been delaying the listing and are not very likely to be able to successfully complete the procedure (see Appendix C – StarMedia and ElSitio Share Prices). "Going forward, it remains unlikely that a substantial pipeline of venture-backed Latin enterprises will be able to pull off NASDAQ IPOs."[18] This might also not be advisable in a broader context, as the local markets will lose even more appeal if the most interesting players move to the U.S.

However, getting listed on a local stock market is also out of question for the majority of these companies. Only on Brazil's main stock exchange, the BOVESPA, a limited number of companies were listed during the last years, although the growth of listed companies has stagnated and market capitalization has declined. The Chilean stock market has not seen an IPO since 1997.

The lack of a shareholder culture among the South American public has contributed to the lack of liquidity on the stock markets. Reasons for the absence of such culture are

[17] Source: Merval, BOVESPA, Bolsa de Comercio de Santiago

[18] Latin American Private Equity Review & Outlook 2000/2001, p. 23

manifold, with the unequal income distribution and insufficiently protected minority shareholder rights being two important ones. The unequal income distribution leads to a situation where a large part of the population does simply not possess the required financial resources to invest in the stock market, whereas a number of extremely rich individuals often park their capital outside of the country. Apart from making stock market investments unfavorable among the general public, the lack of minority shareholder protection means that financial investors have to incur increased costs. They must negotiate shareholders agreements in single cases and often even amend company bylaws to make sure that their rights are protected.

“The distinction between voting and non-voting stock is another area where some Latin American companies violate what foreign investors understand as good corporate governance practices. On BOVESPA (…) up to two-thirds of a company’s shares can be designated as preferred, or non-voting. This means that a shareholder can control a company by owning as little as 17% of the total shares (…). While Chile has taken action on behalf of minority shareholders, the Brazilian congress is debating a bill (…), in Argentina, the government has yet to show significant interest in the issue.”[19]

Nonetheless, the IPO dream is currently revived as the BOVESPA has set the framework for a new market, the Novo Mercado, which has strict regulations and transparency rules, following U.S. and European examples. 26 companies have already indicated an interest in being listed, with 15 more planning to move over from the traditional BOVESPA. The first new company to be listed will most probably be Microsiga, which currently delays the listing because of the uncertain market environment in the light of the Argentina crisis.

If this initiative is successful, the Brazilian market will see increased liquidity because higher transparency in companies’ performance, ultimately also driving up valuations. This in turn will give many private equity players the desired exit opportunity. This money could be reinvested anew, making fresh funds available for the private equity and venture capital sectors.

3.2.8 Foreign Direct Investments

Due to the low liquidity in the local stock markets, most private equity and venture capital investors rely on strategic sales as the only exit opportunity, because an IPO is

[19] Latin American Private Equity Analyst, February 2001, p. 13 ff.

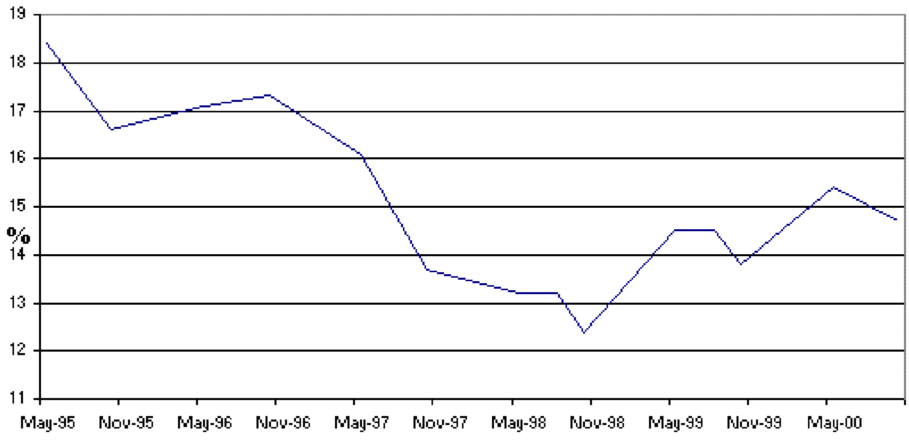
totally out of range. But even the number of executed strategic sales is very limited. Of around 500 investments in the region during the last five years, only 20 have seen a successful exit.[20] Many private equity investors have not yet been able to show returns, a fact that limits their access to fresh capital even further.

Some investors place their hope on rising amounts of foreign direct investments in the region, which had in the past occurred partly as acquisitions of local companies from international players. After the record year of 1999 when foreign direct investments into the three countries rose from US$40.8 billion in 1998 to US$61.9 billion, the trend is already cooling off with an expected US$47.7 billion in 2000. The coming years will show if foreign direct investments will continue their upwards trend from the 1990s or will decrease again when investors lose their interest or faith in the region.

3.2.9 Unemployment

Argentina, Brazil and Chile alike currently exhibit an elevated rate of unemployment. In Argentina, this figure is highest at 16.4%, while it is at 9.6% in Chile and at 6.4% in Brazil[21]. This circumstance is particularly painfully felt in Chile, where unemployment was stable at the 5% mark until 1997, and in Argentina, where it was at 12.9% three years ago. The relatively poor provision by social security in these countries makes the unemployment rates only partly comparable with unemployment figures in developed countries, where the effects of unemployment are less harshly felt by the affected.

Figure 12 - Argentina - Unemployment 1995 - 2000[22]



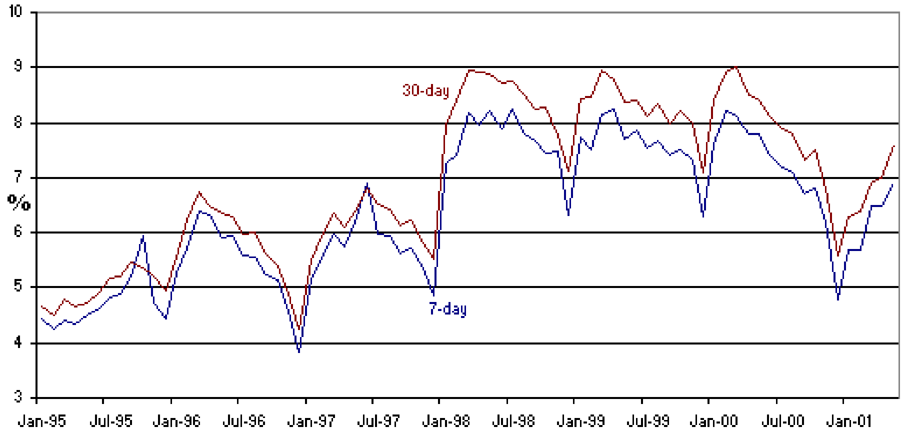
[20] Latin American Private Equity Analyst, March 2001, p. 14

[21] http://www.latin-focus.com

[22] Source: Instituto Nacional de Estadisticas y Censos, Argentina

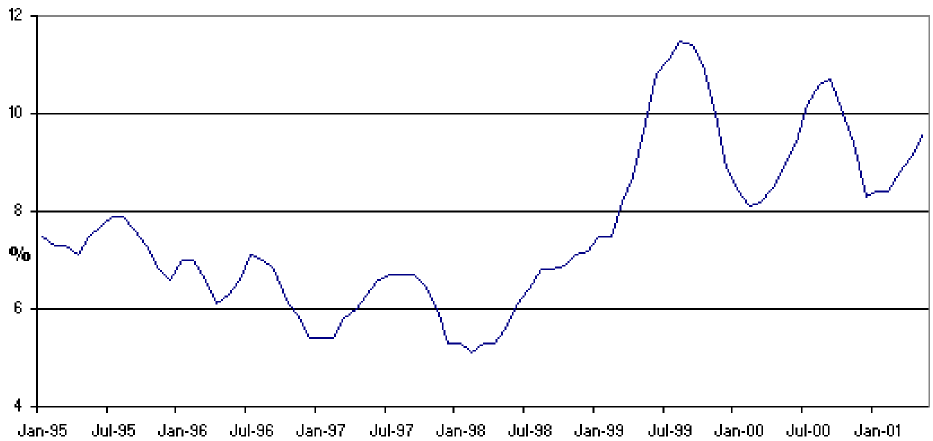
The rate of unemployment has two contrary effects on the portfolio companies of venture capital firms. On the one hand, unemployment slows domestic spending, which has a particularly adverse effect on recently created companies. Their reliance on revenues as milestones for further financing rounds, as required by many investors after the NASDAQ correction, does usually not allow room for decreasing revenues.

Figure 13 - Brazil - Unemployment 1995 - 2001[23]



On the other hand, an oversupplied labor market offers opportunities to startup companies. Unemployed entrepreneurial individuals might think about starting their own business while looking for a new job. This occurred frequently during the Internet hype, when Argentina had the highest number of Internet startups in the region despite being much smaller than Brazil.

Figure 14 - Chile - Unemployment 1995 - 2001[24]



[23] Source: Instituto Brasileiro do Geografia y Estadistica, Brazil

[24] Source: Instituto Nacional de Estadisticas, Chile

In times of high unemployment, companies, including startups, are therefore able to find cheap, highly qualified employees. While the current economic crisis in Argentina prevents many of the former founders of failed Internet companies to go back into their traditional jobs, they may consider new employment elsewhere in the arena of young companies.

3.3 History of Risk Capital in South America

Despite of minor differences in the exact historical development of risk capital investment activity in Argentina, Brazil and Chile, there has been a strong common trend throughout the three countries. Therefore, this section aims to provide an overview of the regional development, before each country will be analyzed individually in a more detailed manner.

3.3.1 Phase I: Privatization (1980 – 1994)

During the first three quarters of the 20th century, the concept of equity participations in private businesses by financial agents was practically non-existent in South America. There had been no equivalent to the buyout model, i.e. the practice of acquiring stakes in private companies with the intention to add value to the respective company by restructuring or growing the business. Originally developed in the U.S.A, this model was only much later adopted in South America.

Privatization Programs

One reason for the lack of buyout activity in South America until the 1980s can certainly be found in the limited number of opportunities during the preceding decades: The existence of large monopolies and state-owned enterprises in many economies throughout South America did not leave much room for private acquisitions in the region. This impediment began to fall when the governments of Argentina, Brazil and Chile decided to privatize many of their state-owned activities. This took place in sectors such as insurance and mining, and in utilities like petroleum, power and telecommunications. Previously state-owned conglomerates were often split up into their former business units and sold off to private investors in pieces, thereby creating more liquidity from the interested buyers.

As many of these formerly state-owned companies were marked by vast inefficiencies, the privatization programs by the South American governments created abundant opportunities for turn-arounds. Insurance companies and banks were first to exploit these opportunities in the market, because their strategic business interests in the region made them more comfortable with the associated risks. Also, influential local family groups, often controlling large industrial conglomerates, engaged in the acquisition of privatized small and medium sized companies. Their acquisition activities had mainly the strategic intention to diversify their industrial conglomerates, but in hindsight this involvement has clearly had an expediting effect on the development of private equity investing in South America by setting an example in the practice of taking a considerable stake in private companies.

Improving Economic Environment

During the 1980s and early 1990s, many South American countries were stifled by economic crisis, most visibly in rampant hyperinflation. At the same time that privatization programs have taken place in the region, however, the longer-term foundation for increased political and economic stability was laid. Argentina returned to civilian rule in 1983, Brazil in 1985, and Chile saw its first free elections after the Pinochet dictatorship in December 1989. The return to democratic rule in the region was an important requirement for foreign investors to consider this region for business. At the same time, South American governments have worked to dismantle the legal and regulatory discrimination against foreign capital. In Brazil, for example, international investors were allowed into the stock market in 1991.[25]

Towards the end of this phase, the first number of pure private equity players appeared on the scene, specialized in tapping into the opportunities that were provided by the improvement potential in privatized companies. A number of local companies were the first to engage, such as CRP Investments in Brazil in 1982, while later, in 1992 and 1993 respectively, “two management firms in particular set the tone for investing in the region: Argentina’s Exxel Group, and Brazil’s GP Investimentos. Both attracted U.S. institutional investors by offering a combination of U.S.-style buyout techniques and a thoroughly local market presence.”[26]

Many of these U.S. institutions were banks that already had a presence in the South American market, either in retail or commercial banking. In some cases, they had simply realized the investment opportunity and set up private equity investment funds to exploit it. In other cases, these banks already owned “equity stakes in private

[25] Latin American Private Equity Review & Outlook 2000/2001, p. 29

[26] Latin American Private Equity Review & Outlook 2000/2001, p. 38/39

companies through debt-for-equity swaps and other schemes designed to pull banks and companies out of the depths of the debt crisis that befell the region during the 1980s. These ‘accidental portfolios’ exposed banks (…) to the opportunities for developing a private equity business in the region.”[27]

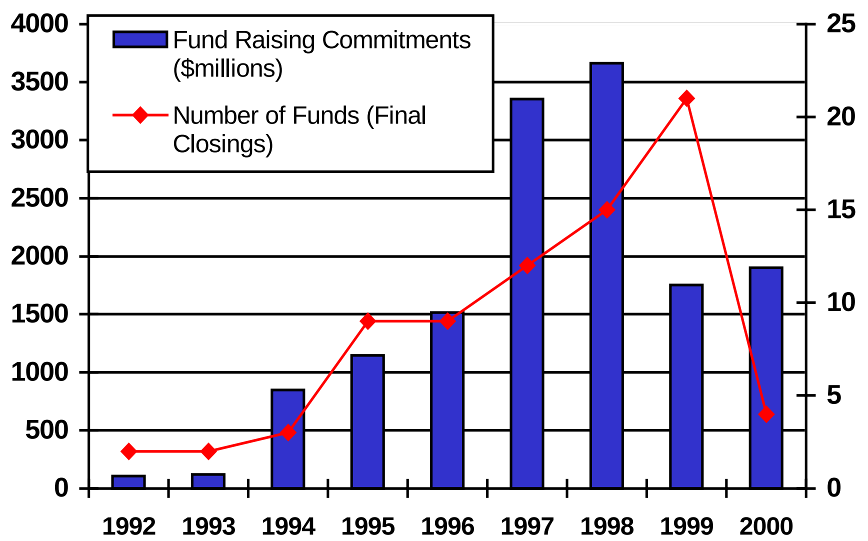
The Role of Family Businesses

Many small and medium sized family businesses embraced the chance to cash out or grow with the help of equity investors. Globalization had put considerable pressure on these companies on the dimensions of price and quality, while at the same time debt financing was available only at high prices. In addition, raising money through stock markets was out of question for many companies. The access to international capital markets required a certain minimum size unattainable by many South American family businesses and would often require the loss of control, while local stock markets were already suffering from a lack of liquidity. This constellation made equity investors the most viable option for South American family business owners to develop their companies.

3.3.2 Phase II: Private Equity (1995 – 1998)

The privatization phase had laid the groundwork for private equity investments in Argentina, Brazil and Chile. Several companies had already embraced the resulting opportunities, mainly local companies that were familiar with the market environment.

Figure 15 - Latin American Private Equity Fund Raising 1992 - 2000e[28]



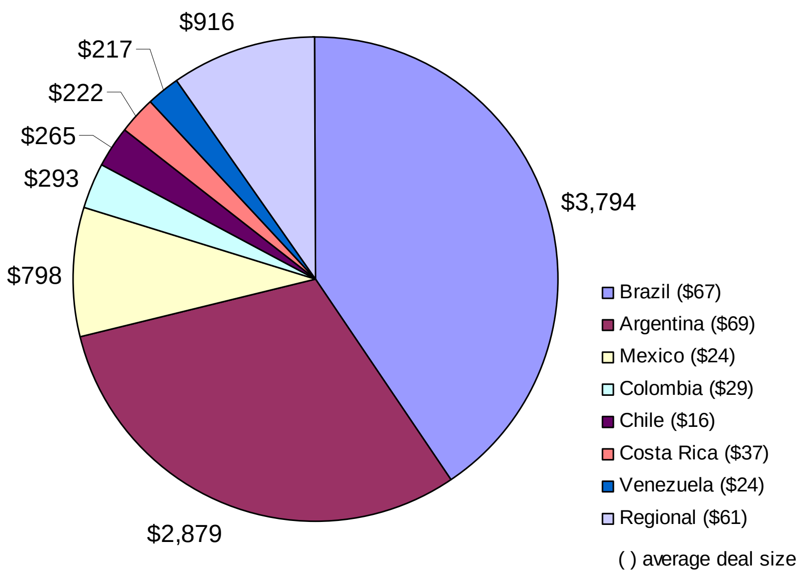
[27] Latin American Private Equity Review & Outlook 2000/2001, p. 47

[28] Source: Latin American Private Equity Review & Outlook 2000/2001

During this ensuing second phase, the private equity model proliferated throughout South America with an increased presence of U.S.-American institutions and higher professionalism. Private equity investments created an increased awareness of private financial participations, and therefore, this phase is particularly important for the proliferation of venture capital in South America.

Arguably, the year 1995 marked the beginning of real private equity activity in South America. More U.S.-American banks embarked on the opportunities in the region. Private equity activity focused on the strongest economies in South America with regard to size and stage of development, making Argentina and Brazil the preferred targets. Apart from opportunities arising from privatization programs in these countries, private equity firms continued to invest in other growth companies, restructuring opportunities and industry consolidation, often of family-owned businesses. In the eyes of many investors, there were many middle-sized companies in South America at that time that needed funding to face the prevailing challenges. Beyond that, "only the region's blue chip companies have had consistent access to raising long-term financing from international financial institutions, or on local or overseas stock markets. However, beginning in the mid-1990s, many of the region's companies were facing deregulation and competition, and needed capital to invest and compete."[29]

Figure 16 - Private Equity Investments by Country 1996 - 1998 (US$ million)[30]



[29] Latin American Private Equity Review & Outlook 2000/2001, p. 51

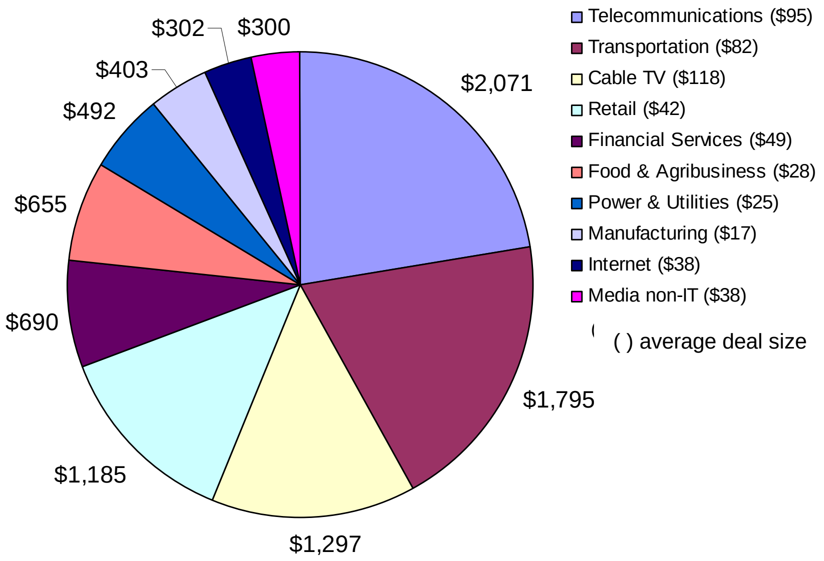
[30] Source: Latin American Private Equity Review & Outlook 2000/2001

Even during this second period, venture capital was a rare occurrence in South America with only two funds raised until 1997, while in the U.S., US$13 billion had been invested in the same period. Also, other private equity techniques that were commonly deployed in the U.S., such as LBOs, did not take on strongly throughout the region, mainly because of the high prevailing interest rates. Defying the trend as a rare exception, “Exxel raised a dedicated partnership for a leveraged buyout, one of the region’s first and only cases.”[31]

Reasons for the Entrance of private equity Firms

Both internal and external reasons led to the increase of private equity capital that was flowing into the South American region during this second phase. Internally, privatization programs continued throughout South America, as shown by the 1998 flotation of the Brazilian telecommunications monopoly Telebras for US$19.3 billion. Following the practice already established in earlier privatizations, Telebras was split into twelve different holding companies, which were sold by the government to private investors. And among the external reasons, U.S. based private equity funds took an interest in emerging markets in an effort to expand beyond a maturing U.S. market for investment opportunities.

Figure 17 - Private Equity Investments by Major Industries 1996 - 1998 (US$ million)[32]



[31] Latin American Private Equity Review & Outlook 2000/2001, p. 40

[32] Source: Latin American Private Equity Review & Outlook 2000/2001

Difficulties encountered

Many private equity investors encountered unexpected problems in their attempt to exploit investment opportunities in South America. Instead of one central reason, this negative performance was based on an array of causes, the most important of which are listed below.

<u>Unfamiliarity</u>

Where the buyout targets did not originate from privatization, they were mainly family businesses, and the family members, albeit looking for the inflow of additional capital, would often be unwilling to give up control of their business. Apart from tradition and pride of sole ownership, this behavior also originated from the circumstance that the South American business community was widely unfamiliar with the concept of equity participations in private companies. Accordingly, the number of investment opportunities was smaller than initially anticipated, and the process of educating family business owners in the region drove up the required duration to close a deal and the associated costs.

<u>Legacy Systems</u>

Further difficulties arose because of two different types of legacy systems in the target companies: management and business control systems. The management in place was a challenge as it often originated from close family networks, which were difficult to overcome. More than often, the problem was not only to get rid of the old management, but also to find good new local management to replace it with. And secondly, the established business control systems were frequently insufficient, which became particularly apparent in the widespread lack of sound accounting systems.

<u>Hidden Contingencies</u>

Covert fiscal or labor contingencies often existed in the companies eyed by private equity firms, making these investments considerably more risky. The private equity companies faced an additional challenge by the lack of organized, easily obtainable industry information, which increased transaction costs. In order to face these challenges successfully, a fruitful combination of local experience and experience in managing a private equity fund was needed. However, purely local funds often lacked the experience of how to successfully manage a fund, while the U.S. institutions, albeit experienced in private equity, entrusted the management of the fund in local hands and only operated from a ‘remote control’ position from abroad.

Missing Exit Opportunities

As if it was not already difficult enough to successfully manage private equity investments in South America, as investing continued it became obvious that it was much more difficult to exit from the investments than anticipated. Exits in public financial markets were extremely difficult, given the lack of liquidity at the local stock exchanges, leaving sales to strategic partner as the most important remaining option. Apart from the heavy dependence on third parties, this option required a much larger time horizon than planned. One problem of this lack of exit options was the fact that the profitability of the private equity concept in South America in general was not proven, in fact, so far never has been since the very beginning of private equity investing in South America. "Limited partners had been willing to take on the added risk of emerging markets, coupled with an investment strategy as yet unproven in Latin America, in hopes of achieving exceptional returns. However, many of their basic assumptions – such as increasing macroeconomic stability, expanding capital markets, and the adoption of internationally acceptable standards in accounting and disclosure – were not borne out. Private equity firms had achieved so few successful exits that there was no proof that returns would justify the additional risk."[33]

Adverse Macroeconomic Development

"The heady times, however, ended abruptly by late summer that year [i.e. 1998], when Russia defaulted on its loan payments, and all eyes turned to Brazil as the next domino to fall."[34] The ensuing devaluation of the Brazilian currency in January 1999 stoked the pessimism that had spread among many investors, and many funds were put on hold. In the typical South American domino fashion the negative situation in Brazil soon had its effects on neighboring economies as well. It spread to Argentina, and from there to Chile, marking the beginning of economic crisis in these countries that still lasts until today.

Despite its lack of success, a Latin American private equity model was evolving. "The industry had become more widely accepted, and fund managers began moving away from the early, generalized fund strategies. In a reflection of their optimism about the wealth of opportunity in the region, they began to organize partnerships to target a specific country, group of countries, or industry."[35]

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[33] Latin American Private Equity Review & Outlook 2000/2001, p. 41

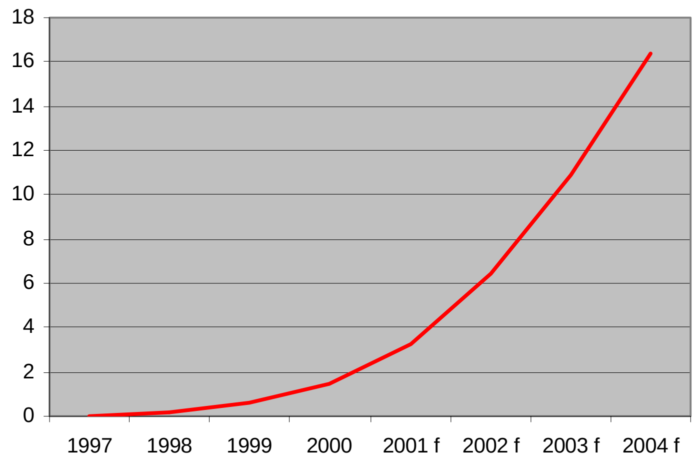
[34] Latin American Private Equity Review & Outlook 2000/2001, p. 41

[35] Latin American Private Equity Review & Outlook 2000/2001, p. 40

3.3.3 Phase III: High-tech Frenzy (1999 - 5/2000)

1999 saw the beginning of an investing frenzy throughout the region, focusing on Internet and high technology businesses. Many investors, local and foreign, believed to have found what they deemed to be untapped opportunities for Internet businesses, and the forecasted growth for e-commerce in South America added even more momentum.

Figure 18 - Latin American E-commerce Spending, US$ billion[36]



Typical investments in this phase were considerably smaller in size than previous private equity participations, ranging from sums as low as US$50,000 to amounts of up to US$10 million. The development of fund raising in the region therefore shows a higher number of funds in 1999, but a much lower overall volume than in 1998 (see Figure 15). Many private equity investors had set up funds for this investment category, while the presence of foreign banks in the region still increased, marked by examples such as Chase Manhattan Bank, Goldman Sachs, Merrill Lynch, JP Morgan, UBS Warburg and CSFB.

Private Equity Investors engage in Venture Capital

The fact that many of the private equity players embraced these new investment opportunities was particularly understandable in the light of the poor performance in their traditional segments. Internet investments proposed returns of 20 to 25 times the amount invested while traditional private equity would only yield three to five times.

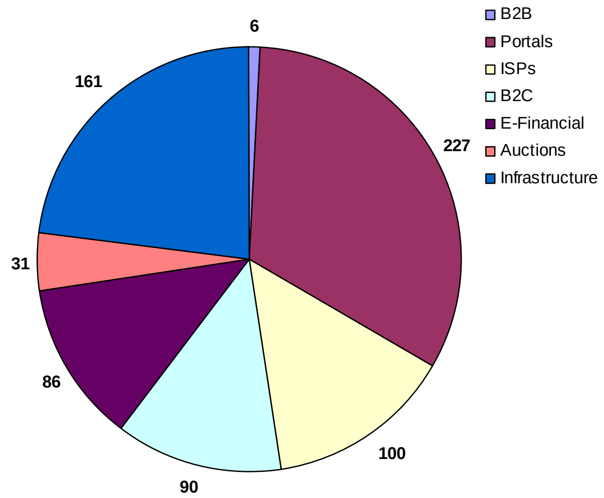
[36] Source: IDC, Latin America Internet Commerce Market Model 2000

Additionally, this new asset class promised to provide a better basis with regard to the difficulties that private equity investors had faced during the second phase, as discussed above. New Internet businesses would be free of any contingencies and legacy systems, and the younger generation of Internet entrepreneurs was reckoned to be more willing to accept equity partners in their companies than a family business owner who runs a company in third or fourth generation.

Private Venture Capital Players emerge

At the same time, the venture capital model proliferated in the strong economies of South America. This had not taken place during the preceding phases mainly because of regulatory obstacles to the issuance of stock options and equity compensation, illiquid stock markets, a low level of technology absorption, and a low level of entrepreneurship.[37]

Figure 19 - Internet Investments in Latin America 1999 (US$ millions)[38]



The year 1999 "marked a turning point in the kind of funds institutions were backing. Five venture capital funds – a category that barely existed in the region before that year – accounted for US$194 million of the funding raised, about 11% of the total. The development reflected the surge of Latin American Internet startups, and the enthusiastic reception they received after StarMedia and ElSitio went public on NASDAQ."[39] In fact, besides the portals StarMedia and ElSitio, also Terra Networks, Spanish Telefonica's Internet subsidiary, went public on the NASDAQ in 1999.

[37] Latin American Private Equity Review & Outlook 2000/2001, p. 58

[38] Source: Bain & Company

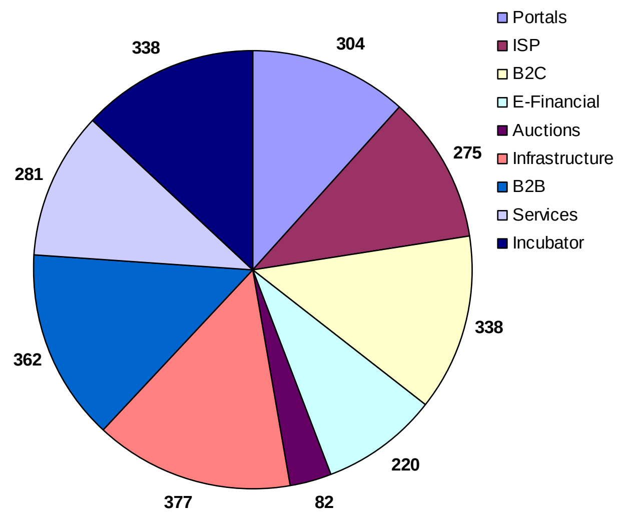
[39] Latin American Private Equity Review & Outlook 2000/2001, p. 42

This success clearly fueled the investment frenzy in Internet businesses in the region. Local startups were now also able to raise more money from wealthy individuals who acted as business angels.

Investment into Hype Trends and Shaky Foundations

In this third phase between 1999 and the first half of 2000, many investments clearly followed hype trends rather than sound fundamental analysis. At the end of 1999, portals were the main investment targets throughout South America, while the beginning of 2000 saw increased investments into free ISP's (compare Figure 19 and Figure 20). In the months before the NASDAQ correction, incubators have received increased attention from investors. For a while, the few Internet business triumphs in South America seemed to blur the truth that many stock exchanges in the region continued to suffer from a severe lack of liquidity.

Figure 20 - Internet Investments in Latin America 2000 (US$ millions)[40]

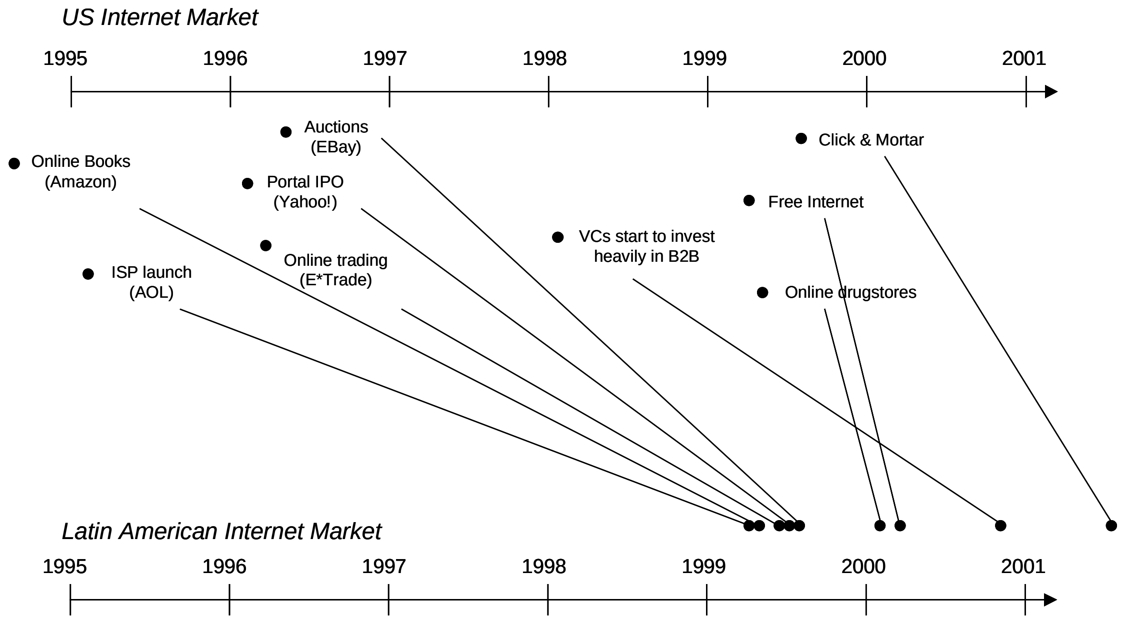


In a remarkably unwarily manner, many investors refrained from conducting a fundamental analysis of their investments, but rather speculated on compliantly increasing valuations to get rich quickly. This carelessness often turned out fatal, as many entrepreneurs had adopted a similar approach, equally abandoning the concept of validating the viability of their business idea. Both sides believed that the miraculous, novel Internet technology would allow for such omission, or that there must be something right about the exuberant situation when the respective other side would play along in such favorable manner.

[40] Source: Bain & Company

The development of the Internet sector in South America took place in a similar fashion to the situation in the U.S. during the preceding years, however, at a much faster pace. There were certainly many lessons to be learned from North America, yet the sound creation of any company requires a certain minimum time, regularly longer than the few months that Internet fever reigned throughout the continent. As a result, of the companies created during the days when Internet investing boomed in South America, many were built on shaky foundations, causing even more failures when capital sources dried up as a result of the NASDAQ correction.

Figure 21 - Development of Internet Sector in the U.S. and South America[41]



3.3.4 Phase IV: Restructuring (6/2000 – 8/2001)

Capital Sources dry up

The NASDAQ correction in March 2000 had its effect on the South American environment with a delay of approximately three months. By August that year, investors had adopted a much more cautious approach, while the majority of them completely froze new investments. The number of investments dropped 50% in the second half of 2000 with roughly 30 to 35 new commitments compared to 65 during the first half of the year.[42] Most of the small funds that had been created during the hype period shut down their operations as quickly as they had appeared. Apart from rare cases such as

[41] Source: Bain & Company

[42] Source: Stratus Investimentos and Latin American Private Equity Analyst

Eccelera and Softbank, no new investments were entered into, and the focus was shifted on implementing cost-saving measures in the startup companies.

To this end, investors regularly adopted a much more hands-on approach, where they would put tighter controls on the portfolio companies, and often send a trusted manager into the startups to define a way out off the crisis. A few follow-on investments in existing portfolio companies were entered into by investors if they deemed this necessary and useful to save the respective business. Also, only few of the established incubators still remained. The deal flow dried up considerably, as most of the purely opportunistic entrepreneurs withdrew from the scene. Average numbers obtained during the interviews show a reduction from 150 - 200 received opportunities per month in early 2000 to only 40 in recent months.

To strengthen their position, many investors today seek control in their investments, because minority participation gives only limited influence, and rights are very difficult to enforce on the majority shareholder. This situation was especially difficult for U.S. banking divisions, which were not allowed to take a majority stake until March 2000. In any case, venture capitalists today acquire large portions of the portfolio companies already in early rounds. Interviewees were on average looking for a 35% share when investing.

Many of the private equity funds that had set up funds for smaller investments, i.e. in the venture capital range, have retreated to their original larger investments categories. In most cases, they have redirected the capital that they had reserved for venture capital investments to their traditional fields.

Positive Effects of the NASDAQ Correction

At the same time, however, the NASDAQ correction had positive effects for the risk capital investing community, as well. The correction lowered valuations considerably, thus equity was available at much lower cost. Also, business plans would improve in quality, and the reduced number of overall deal-flow to venture capital companies made more thorough reviews of the opportunities possible.

It can also be argued that it was positive that the NASDAQ correction had occurred so early during the development of the South American Internet market. Many fund managers, be it of newly established venture capital funds or private equity funds that had moved into the space of small investments, were inexperienced with the phenomenon and therefore often made unwise financial commitments. In this context, the timing of the NASDAQ correction was good, as it prevented "regional fund managers from further flooding immature markets with insufficiently defensible B2C and B2B companies, as occurred to varying degrees among Latin American ISPs, portals and C2C auction sites prior to the correction."[43]

The year 2000, however, also saw the emergence of a few highly serious venture capital players that entered into the market with a long-term focus. They believe in the value of the venture capital model and that it is applicable to South America. They combine good fund managers with hands-on management of the portfolio companies, thereby acting right on two dimensions that had been clearly underdeveloped in many cases where venture capital firms had failed in the region in previous years. Also, these companies now often have a regional business approach, covering Argentina, Brazil and Chile altogether, which allows easier access to capital from limited partners abroad, as they tend to see the region as one block rather than to distinguish between the single countries. A regional approach will also improve deal flow quantity and quality because of an increased coverage. In this fashion, focusing on a certain business segment can be a viable investment strategy.

3.4 Current Situation

3.4.1 Chances

Notwithstanding the negative effects that the NASDAQ correction had on the South American region, there are vast opportunities in this continent. This situation becomes clear when considering that in South America, opportunities for equity investments derive from two different sources: On the one hand, just as elsewhere in the world, private equity and venture capital investors will be able to exploit the business opportunities, based on growing entrepreneurial activity in the region. On the other hand, these investors will be able to reap additional opportunities from the fact that equity investment concepts are still in a maturing state in South America, where the low amount of capital will likely lead to more favorable valuations. Investors in any case are still positive about the development of the sector, with interviewees indicating on average an expected IRR of 35% for their investments.

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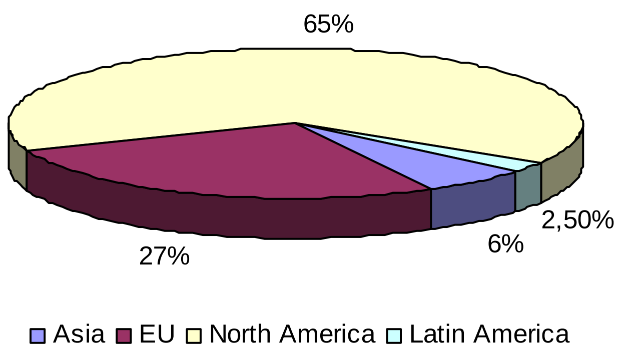
[43] Latin American Private Equity Review & Outlook 2000/2001, p. 71

The fact that risk capital investing is today still in a maturing state in South America also stems from the timing of the NASDAQ correction. As a result of this correction, both startup companies and private equity investors throughout the continent were faced with a negative market environment early on in the development of their sectors. This stands in contrast to the situation in the U.S., where the crash of many high technology stocks occurred when both the technology industry and the investing sectors were in a much more mature state. In other words, South American venture capital and private equity companies were not able to develop sufficiently before the NASDAQ correction, which provides potential for development once the aftermath of the crash will be absorbed. Now, with the basic regulatory and industry structures in place, equity investing can start into a new era in South America. It remains to hope that the early shakeout does not lead to a burden so heavy for the young venture capital sector that it will struggle to survive. But the failures many firms incurred during the past years may well have been what it takes to build such a sector from scratch.

At the same time, the South American economies continue to transform itself in the light of increased globalization, where many small and medium sized companies are forced to boost efficiency. Many of these businesses still consider selling as a viable option to respond to this trend, thereby creating opportunities for professional equity firms in the region. Moreover, MERCOSUR, NAFTA and several smaller economic unions have contributed to a new international framework in South America, thereby adding dynamism to the region.

Figure 22 - Private Equity Investments Worldwide 2000[44]



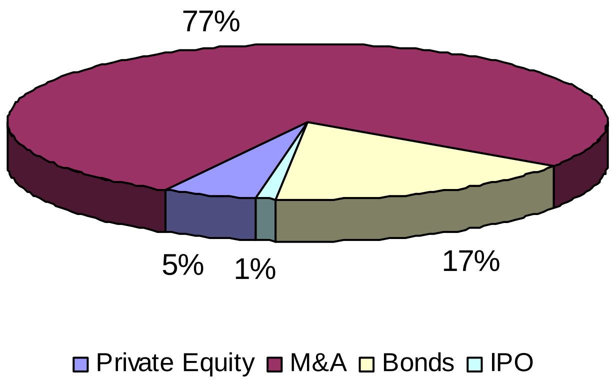
[44] Source: Internal study of interviewed private equity investor

3.4.2 Challenges

One challenge for risk capital investments in South America already arises from the cultural difficulty associated with the word risk. The downside potential inherent to the concept of risk strongly prevails over the possible upside potential, reflecting a lack of understanding of the fundamental characteristics of venture capital investments.

The problem of equity investing in South America over the past three years can partly be traced to a broader global pattern. Because of the Asian crisis and many disappointed expectations in South America, many investors from the U.S. and from Europe have lost much of their interest for investing in emerging markets.

Figure 23 - Investments in Latin America per Category 2000[45]

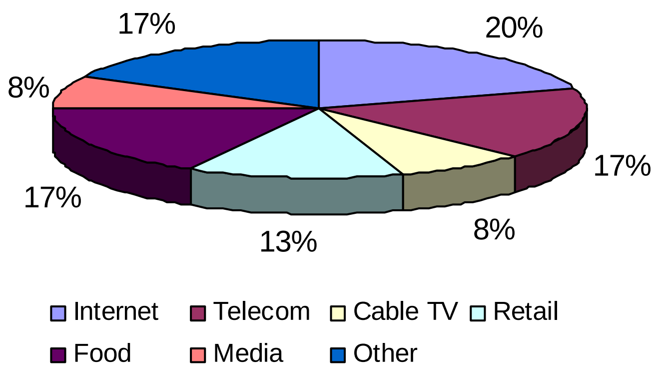


Despite of the abundance of opportunities, a proof of the viability of the venture capital and private equity industry in South America will still require a broader history of exits from these investments. This will also determine how new and existing firms in the region will raise capital from limited partners. The fund raising difficulties in the past "can be traced to the largely lack-luster performance of the investments already made. Not only have there been relatively few exits, but private equity investors are also faced with a large stock of holdings from which they have no easy way out. Only a few firms have demonstrated an ability to generate returns commensurate with the risk of investing in a still-emerging market."[46]

[45] Source: Internal study of interviewed private equity investor

[46] Latin American Private Equity Analyst, May 2001, p. 15 ff.

Figure 24 - Private Equity Investments by Sector 2000[47]



From Figure 22 and Figure 23 the lack of interest in private equity in South America is obvious. The internal investor's study projects demand for private equity in 2001 to reach US$5.3 billion. US$2.9 billion are funds still available from 2000 and US$1.9 billion is expected to be fresh capital, leading to a total supply of US$4,8 billion. Compared to demand, this leaves the market with a lack of US$0.5 billion, reflecting the scarcity of capital that was observed in many interviews.

3.5 Venture Capital in the U.S. and in Europe

3.5.1 History

The U.S. and Europe have seen the emergence of a venture capital sector far earlier than South America, and are therefore regions that might provide lessons to the players who currently strive to develop such sector in the emerging market. In the U.S., venture capital investing started in the 1950s[48], similarly to the situation in Europe, where a venture capital sector also started in the post-war years but did not experience significant growth until the 1980s. Since then, a cumulative total of more than US$125 billion had been raised in Europe. The U.S. now holds an estimated number of 900 venture capital firms, raising US$35.6 billion in 1999 alone. Ever since the buyout wave in the 1980s, MBOs and LBOs form an important part of the private equity activity in both the U.S. and in Europe.

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[47] Source: Internal study of interviewed private equity investor

[48] http://www.assetnews.com/ped/primer.htm

Early on, North America has seen the creation of venture capital organizations. The American venture capital Association was founded in 1973, while the Canadian counterpart followed one year later. The same applies for Europe: The European venture capital Association started in 1983, and now boasts more than 800 members, while most of the continent's economies hold an additional local venture capital association.

3.5.2 Comparison to South America

The developing venture capital sector in South America can potentially draw on the experiences of the other two regions, which have already seen the evolution of such a sector.

Throughout the 1980s and 1990s, venture capitalists in Europe have experienced difficulties to exit from their investments, a situation all but uncommon to South American investors. A study by Price Waterhouse Corporate Finance[49] indicates that 70% of a panel of venture capitalists interviewed had at some time encountered these exit difficulties. The reasons for this adverse situation were dull stock markets, a lack of institutional buyers for IPOs as well as the lack of trade buyers, uncooperative managers or co-investors, the poor performance of the respective portfolio company or due diligence results.

Many of these occurrences resound throughout the South American venture capital scene at the moment. Exits are difficult for the same reasons as mentioned above. As the result of the studies indicated, however, the problems in Europe could be overcome with proper planning. Many venture capital firms were accused of having adopted a myopic view, not taking into consideration a sufficient number of strategic buyers, for example. It can be reasonably doubted if such solution would solve the difficulties in South America.

As opposed to the historic situations in the U.S. and in Europe, venture capital in South America aims to take hold in an emerging market environment, which leads to a set of differences that make a direct transfer of experience difficult. The high prevailing interest rates in South America make leverage techniques practically infeasible, thereby effectively cutting out an important part of activity that the emerging sector in more developed countries was able to rely on.

[49] Wall, John (1997)

When venture capital investing started in the U.S. in the 1950s and 1960s, individual investors played an important role, initially more so than institutionalized funds. This form of investment in young companies gave room for the surge of venture capital funds, and saw a new focus of attention in the past decade when the phenomenon of business angels became more popular again.[50] The situation in South America looks somewhat different in this regard. The emergence of risk capital is less driven by the contributions of individual investors, as the access to this type of capital is generally very restrictive and often reserved for family members or close friends.

On the other side, venture capital in South America already includes strong involvement from corporate efforts to exploit the region's business opportunities. Popularity of corporate venture capital in the U.S. has not occurred until later in the sector's development. This could actually translate into an expedited process of venture capital maturation in South America, as well as the early effort in Brazil to join the interests of venture capital firms in the Brazilian Venture Capital Association.

3.5.3 Conclusions

A possible conclusion from this comparison is that South American venture capital investors can learn a lot from their U.S. and European counterparts in topics that are inherent to the venture capital concept such as investment techniques. At the same time, it seems that there is less to learn about the development of the sector from scratch, given the different environments in the regions. Asia as a region with numerous emerging economies might provide a successful benchmark example in the foundation of a venture capital sector, but it would definitely be hard to determine which emerging region would have more to learn from the other, South America from Asia or vice versa.

In Europe, it has roughly taken twenty years to build the venture capital sector. In 1996, Coopers & Lybrand Corporate Finance conducted a study with 2,190 venture-backed companies in twelve European countries[51]. Of the 500 respondents, over 80% believed that their business would not have existed or grown much slower without the involvement of the venture capital investor. The latter owned on average 46% of the startups' equity, underlining the important role that these firms played for the young

[50] www.nvca.org

[51] Geary, Michael / Noël, Albertus: The Economic Impact of Venture Capital in Europe (1996)

companies. This demonstrates the potential impact that an established venture capital sector can have on an economy and thereby should form a target for South American entrepreneurs and investors alike.

4 Country-specific Analysis

4.1 Argentina

Overall, we conducted interviews with 26 experts in Argentina: one business angel, three venture capitalists, four private equity investors, one incubator, seven startups, two professors, three consultants, one lawyer, and four other experts.

4.1.1 Economic Overview

Argentina is a nation of 36.7 million people with 40% of the population and half of the national industrial production located in and around the capital Buenos Aires. Important secondary cities are Cordoba, Rosario, Mendoza with over one million in population each, and Neuquen. Argentina returned to democracy in December 1983. President Fernando de la Rua's October 1999 landslide victory and January 2000 inauguration followed ten years under Carlos Saul Menem.

Table 1 - Argentina - Overview of Macroeconomic Data[52]

		1996	1997	1998	1999	2000	2001	2002
Nominal GDP	bn	272.2	293.0	299.1	283.4	285.1f	282.1f	290.9f
GDP per capita		7700	8200	8200	7700	7600f	7500f	7600f
GDP growth (real)	% yoy	5.5	8.1	3.9	-3.4	-0.5f	0.5f	2.1f
Exports FOB	bn	24.0	26.4	26.4	23.3	26.3f	27.6f	29.3f
Exports	% yoy	13.6	9.9	0.0	-11.8	12.7f	5.0f	6.0f
Imports FOB	bn	22.3	28.6	29.6	24.1	23.8f	24.0f	25.5f
Imports	% yoy	18.5	28.1	3.5	-18.5	-1.4f	1.0f	6.2f
Trade balance	bn	1.8	-2.1	-3.1	-0.8	2.5f	3.6f	3.8f
FDI (net)	bn	5.3	5.5	5.0	22.9	10.2f	7.2f	6.7f
Total public debt	bn	97.2	101.1	112.5	121.9	128	129.8	136.7
Total public debt	% GDP	35.7	34.5	37.6	43.0	44.9f	46.0f	47.0f

In 1991, Menem re-engineered the economy to reverse six decades of decline, implementing the 'Cavallo Plan', named for the then- and today economic secretary. Argentina implemented important reforms in currency, finance and trade in the face of global competitors with easier access to long-term capital. Additionally, the country opted for complete currency convertibility, a "currency board" to ensure a one-to-one exchange with the dollar and a goal of zero inflation. Yet, overall economic growth did

[52] Deutsche Bank Research (www.dbresearch.com)

not follow. Some years were good, while others were mixed or poor. The Brazilian Real devaluation in January 1999 pushed Argentina into recession. Nearly two years later, the recession continues and shows no sign of receding.[53]

The economic situation today is bad. Argentina is South America's largest borrower with US$128 billion in foreign debt. The ongoing recession with 16.4% unemployment in May 2001 and the continuing trade disadvantage with Brazil lead to a decrease in money inflows to the government, which is slowly pushing the country into bankruptcy. The planned deficit for 2001 was US$6.5 billion, of that US$5 billion were already used by May of 2001. Interest rates skyrocketed with the economy tumbling into a major crisis. In light of the critical situation, the government in July introduced harsh cuts of salaries for state employees and pension payments. After already experiencing open turmoil in some regions, this measure brought unions to initiate a nationwide general strike on July 19th. Some economic experts, such as Paul Krugman, have already considered the default, meaning the loss of ability to pay back the debt, as inevitable.

In June the government approved a measure to promote Argentinean exports, which introduced a new exchange rate on the basis of a 50-50 basket with Dollars and Euro for imports and exports and thereby effectively devaluated the currency by about 8%. The initiative heightened speculations about abandoning the one-to-one dollar-peso exchange rate peg. Although some experts still believe in continuing the peg even after a default, it is quite likely that a default would also trigger an outflow of capital from the country, a local run into the dollar, and speculative pressure on the currency, which would eventually inevitably lead to devaluation and an abandonment of the exchange rate peg, "precipitating an economic crisis that is sure to be borderless."[54]

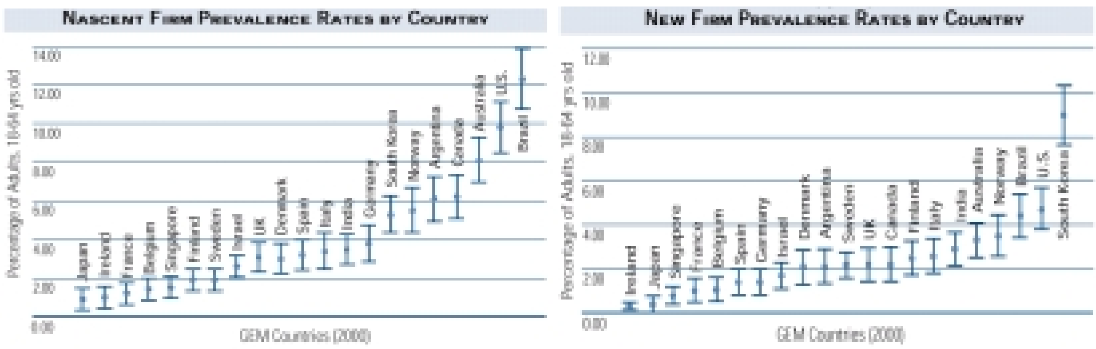
One possible outcome of such devaluation might be a 'natural dollarization' of the country. The dollar has been used for the last ten years alongside the Peso in day-to-day transactions and most debt and many private and company accounts are denominated in dollar. Therefore, it seems likely, that the people itself will adopt the dollar as a currency if the Peso is devaluated. Although most of the population is not very fond of using the 'gringo' money, going back to the days of hyperinflation makes them even more uncomfortable.

[53] McDermott (2000)

[54] *The Economist*, March 2000

Most major non-agricultural business is done by multinational companies (six of top ten), or by Argentine economic groups controlled by one of several dozen leading business families (four of top ten). Despite of the economic difficulties or perhaps even because of them, “Argentina has evolved into one of the countries central to Internet and ‘new economy’ business development in Latin America.”[55] Argentina had the highest number of startup companies in South America, in total about 350[56], with several success stories such as Patagon.com and Officenet. The Global Entrepreneurship Monitor 2000 reports a very high level of entrepreneurial activity in Argentina compared to other countries.

Figure 25 - GEM Report - Entrepreneurial Activity[57]



But the comparison of nascent firms, i.e. firms in the process of being created, where Argentina ranks fifth with new firms that are less than 42 months old where Argentina ranks only 12. shows that this phenomenon is quite recent.[58] With the Internet boom a new generation of entrepreneurs was created, which proves that the country has an enormous potential for venture creation, given that equity financing is available.

4.1.2 History of Risk Capital in Argentina

Risk capital investing in Argentina started only after hyperinflation was brought under control by the dollar-peso peg in 1991. Since 1993, in the wake of privatization, a wave of acquisitions and turnaround operations attracted both international and local funds to the private equity arena. This first wave of private equity was driven by the consolidation of traditional industries, with the management of many companies changing from solely national to being somewhat mixed. Main target sectors included

[55] McDermott (2000), p. 12/13

[56] Las Empresas.com, Business Technology, July 2000

[57] Global Entrepreneurship Monitor, 2000 Executive Report

[58] Global Entrepreneurship Monitor 2000, Country Report Argentina

food processing and agro industry, oil and gas processing, retail, telecommunications, banking and insurance and logistics. In 1999 at least 30 formal private equity investors were in operation in Argentina, which managed a combined asset pool of US$12.4 billion and had funded 160 transactions. In general at this stage, “there was too much money chasing too few good projects”.[59]

In 1998, with the emergence of the Internet hype also a venture capital sector evolved in the country. The Internet hype has been very significant in Argentina, as a high GDP per capita, a high rate of unemployment and a generally quite opportunistic attitude met. Therefore many people started their own company. The Internet was the first time a class of entrepreneurs was getting funded in the region. During the time span of 18 months between 1/99 and 6/00, 368 Internet projects were funded in the region.[60] However, of these companies only about fifty did receive professionally executed funding, thereof approximately 90% from U.S. related investors. Many private equity funds also saw an opportunity and got involved in providing small volume, Internet related investments. This was spurred in part by the US$4 million investment of Chase Capital for a 30% share in Patagon.com in July 1998. The vertical finance portal was sold in March 2000 to Banco Santander at a valuation of US$855 millions. “This remarkable return produced a shift in focus in many funds.”[61] However, most of them were simply joining the wave too late.

Also, few players had real experience in the management of these small investments, thus a lot of ‘dumb money’ was invested during the Internet hype period. The NASDAQ correction in April 2000 did trickle to Argentina around the middle of the year and destroyed many illusions in the young venture capital sector. Few of the initially numerous Internet projects survived the crash, which also affected the investors, with the private equity players drawing back to their territory of later stage investments and several venture capital players and incubators disappearing or holding investments. Puntocom Holdings in Argentina is a typical example: The fund management has moved into the portfolio companies and is now concentrating on turning those profitable.

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[59] Pereiro (2001)

[60] Business Technology, “Las Empresas.com”, July 2000, in McDermott (2000), p. 15

[61] Pereiro (2001)

A small number of venture capital investments were actually successful in Argentina, including Amtec, which was backed by angels Lisandro Bril and Alejandro Etchart and later by Hicks, Muse, Tate and Furst, Chase Capital Partners with Patagon and PCP (Carlos Adamo) with Officenet. These companies also provided the first role models for entrepreneurs in Argentina. Since the middle of 2000, very few significant financing rounds were closed; examples include Bazuca in Chile with US$5 million, Fulano in Brazil with US$4 million and Decidir in Argentina with US$15 million.

After the NASDAQ correction, a new class of venture capitalist fund managers has become more influential, with backgrounds in consulting and investment banking but also significant experience in equity financing. The new venture capitalists generally show a more hands-on involvement, tapping into a tight network and providing knowledge to the respective startup company.

4.1.3 Current Situation

4.1.3.1 Sources for Financing

The following section will present an overview of the different sources that are available for financing for young companies in Argentina.

Love Money

Personal savings are the most frequent form of first financing. 88% of entrepreneurs are using their own capital to start up a company, 27% have received capital from their family. Love money froms the four ‘F’ - founders, family, friends and fools, and is available to a broader extent in Argentina, because the income distribution shows a large middle-class, which can provide small amounts of funds for ventures.

Debt Financing

Banks are seldom used for early stage financing because interest rates are too high and access is difficult for entrepreneurs. Only 20% of entrepreneurs use loans as a source of capital. Other frequent measures of financing include the use of credit from suppliers by paying late (14%) or the use of 2nd hand equipment.[62]

Business angels

Argentina’s business angels are still acting largely uncoordinated, and there does not exist anything like an official business angel association. However, a significant number

[62] Figures taken from Pereiro (2001), p. 23

of angel investors have already made investments in young companies and from the increased activity did evolve the Penguin Circle, a close professionally organized network of influential individual investors, like Wenceslao Casares, founder of Patagon, and Andy Freire, founder of Officenet.

The San Andrés University is currently conducting a study on the business angel community in Argentina and has assembled a database of 45 angels for their survey. The university estimates the total number of business angels in Argentina to be about 1000, but only about 100 are professional and of these less than 20 are active in technology related areas. Still these are significant numbers for an immature market.[63]

Angels are more active and present in Argentina than in Brazil or Chile. Although no formal organization is in place, the awareness of the availability of this investment category seems much higher. Many of the young Internet startups were backed by angels and angel investments are estimated to amount to US$200 million in 2000.[64] The increased importance of angels may also be due to a lower presence of venture capital.

Incubators

Most of Argentina's technology incubators were created during the Internet boom, representing the first attempt on technology business incubation. Most of the incubators had to find private sources for funding due to the lack of governmental programs and support. Usually, incubators received money from venture capitalists or private equity firms. "The usual Argentinean incubator is formed by an angel or private fund, plus a management team usually with a strategic consulting background, coming from firms such as McKinsey, Boston Consulting Group [or Booz Allen & Hamilton]"[65].

However, many incubators set up during the Internet boom were not very well developed and were only driven by the opportunity. They mainly invested in copy & paste ideas and did not adjust the business models to local requirements, such as logistics, delivery, payment mechanisms and bandwidth. Thus, many of the once multiple incubators are either not active any more or stopped investing, while putting the own management into their portfolio companies.

[63] For details on the study contact the Entrepreneurship Center at San Andrés University

[64] Latin American Private Equity Analyst, May 2001, p. 13

[65] Vilan (2000), p. 14

Several universities also have created technology incubators to foster research and development and help the creation of young companies from the research projects. However, "incubators that depend on purely academic sources are (…) not very often, counting an approximate 10% of the total industry."[66] While this percentage has probably increased significantly with the failure of several private incubators, the involvement of universities is still relatively small.[67]

Venture Capital

Argentina does not have much experience in venture capital investing. But the Internet hype has created widespread awareness and served as a catalyst for the introduction of the sector. Despite the recent setbacks, entrepreneurship and venture capital now enjoy greater and more structured attention.

The remaining and the newly formed venture capitalists have gained important experience and are now acting much more professionally while adapting their way of doing business to the local conditions. Examples for this new class of venture capitalists include Pegasus, Softbank, Next International and PCP. Most of them also expand their vision beyond Internet ventures to other industries, as they realized that many markets in Argentina are too small to specialize in one sector alone. Still active are also Intel Capital in corporate venture capital and the Multilateral Investment Fund of the Inter-American Development Bank, that backed several Argentinean venture capitalists like InverPYMES and the Small Enterprise Growth Fund.

Venture capitalists today also indicate that a regional focus is important, because local markets are too small and the integration of markets is increasing. Lack of market size also leads to a situation where most funds cover all industries and sectors. One problem in this environment is the fact that fund managers cannot be experts on every sector, making the due diligence process significantly more complicated. However, one investor commented that this fact could also work as an advantage. If one is aware of one's own partial ignorance, one might not be subject to overconfidence.

Since August 2000, venture capitalists in Argentina very carefully enter into new commitments. The NASDAQ correction had scared them away from technology

[66] Vilan (2000), p. 14

[67] For additional information on the incubation process see Vilan (2000)

investments, and now most of them mainly watch the market. Given the uncertain development of the region in general and the critical situation of the Argentine economy in particular, only very few selected investments have been made in the recent past.

Private Equity

The private equity scene in Argentina is diverse with several local and international players currently active (see Appendix F for list). Three different kinds of private equity funds can be differentiated: (1) independent funds, both local and international, such as the Exxel Group or Advent International, (2) private equity divisions of large banks mainly from the U.S., such as BankBoston or Chase Capital, and (3) corporate private equity, such as GE Capital. Although almost all funds have been active also in early stage financing of companies during the Internet boom, most of them are now focusing on their traditional area of later stage investments.

Because of the lack of exit opportunities from investments, most venture capital funds see the larger private equity players as a potential source for an exit in a later round. In this respect, private equity funds still play an important role in the venture capital space and will continue to do so.

Stock Markets

The South American stock markets are currently not a viable option to raise additional capital. The Argentinean stock market is very small, highly illiquid and declining in importance with daily trading volumes around US$20 million in total. The number of delistings during the last 10 years is significant – “from 186 companies quoting in 1988, only 128 remain, a 31% decrease”.[68] Only thirty of these companies have revenues of US$200 million and more. The situation is leading into a vicious cycle, because for investors it does not pay to look at or even have analysts covering such a small market, which in turn leads to lack of information and decreasing trading. Setting up an IPO in such an environment will hardly prove to be successful, thus this source of capital is nowadays completely out of question in Argentina.

4.1.3.2 Sources of Capital for the Funds

As most of the possible sources for capital for a young company are difficult to obtain in Argentina, venture capital is especially important. This section will therefore focus on available sources of capital for the funds.

[68] Pereiro (2001), p. 9

Pension Funds

Private pension funds manage cumulative assets of US$24 billion, increasing by approximately US$6 billion per year.[69] However, pension funds are not allowed to invest in private equity or venture capital funds or even directly into early-stage companies. Equity investments have to be in companies that meet certain rating agency risk limits.

As interest rates are very high despite of the dollar-peso peg, incentives for pension funds to invest in equity assets are very limited. Although the limit for government bond holdings are at 50% of assets, pension funds manage to hold more than 80% of their assets in government bonds via trust funds and other vehicles.[70]

Banks and Insurance Companies

“Argentine insurance pools are small and, by their nature, are customarily not available for risk capital.”[71] Insurance companies and local banks face the same situation as the pension funds regarding high interest rates. According to the risk-return theory, high-risk equity investments are not feasible in this situation.

Additionally, commercial banks will not fund startups, because in order for them to invest they need to fulfill certain central bank balance sheet requirements, which startups simply will not be able to comply with.

U.S. based Investors

In Argentina, U.S. based investors such as large banks and private equity firms have been a large source of capital since the privatization phase in the early 1990s. “The U.S. is Argentina’s largest investor.”[72] In 1999, more than US$7.5 billion dollars for private equity investments were managed by U.S. institutions in Argentina. Many of these funds also became active in the venture capital sector during the Internet hype. For example, Hicks, Muse, Tate & Furst in early 2000 dedicated a US$50 million dollar fund exclusively to Internet-related ventures, however, in the end only US$20 million were actually invested.

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[69] McDermott (2000), p. 17

[70] http://news.cnet.com/investor/news/newsitem/0-9900-1028-5661104-0.html

[71] McDermott (2000), p. 17

[72] McDermott (2000), p. 14

Many of these funds are covering not only Argentina from their Buenos Aires Office but do look at most of the Spanish-speaking region as they consider the other markets too small. The fact of having only one office for example for the Andean region adds to the undifferentiated point of view of many international investors when it comes to deal with South America.

European Investors

Involvement from Europe in Argentina has been traditionally strong, but only in foreign direct investments, especially from Spain. Investments were mainly acquisitions of Argentine companies by large European players such as Telefonica or Banco Santander. Investments in venture capital funds or related areas were very rare. Exceptions included Antfactory and Europe@web, both of which though are not active in the region anymore.

4.1.3.3 Initiatives

Government

After the liquidation of the development bank in the early 1990s to finance deficit spending by the state, there has been almost no government capital available for the needs of young companies. The government takes a mere facilitator's role rather than an active stance. Politics are understood as the study and creation of laws and regulations in order to pave the road for investments. The Brazilian or Chilean attitude of actively developing the industry is not pursued in Argentina. The government refuses to actively subsidize the startup sector.

Only two very small programs were designed by the Argentine government to aid small companies: FONTAR and FONCAP. The first program ("Fondo Tecnológico Argentino") is a project by the National Agency for the Promotion of Science and Technology, financing projects for modernization and technology innovation by providing subsidies for technological high-risk projects. In 1998, the total volume approved by the government through this program amounted to only US$30 million.[73] The second program, FONCAP ("Fondo de Capital Social") presents an initiative by the Ministry of Social Development and the Environment, providing minor amounts of capital to micro enterprises.

[73] For further information see: http://www.agencia.secyt.gov.ar/ftr/Default.htm

Some Argentinean investors demand from the government more involvement than only the creation of a framework, especially since the lack of early stage and seed financing from the government is particularly noticeable in the market. This view is shared by other studies: “Many interviewees viewed the governments’ task as not only to offer a supportive economic, legal and business climate, but also to assist in the mobilization of national capital resources to support entrepreneurs and early stage small businesses. The examples of other countries that have successfully stimulated venture capital and high value-added industries by means of government guarantees or other inducements are worth investigating.”[74]

Because of the lack of government funds, the evolution of a strong venture capital sector is even more crucial in Argentina than in Brazil or Chile.

University Entrepreneurship Programs

Three universities have, sometimes against substantial opposition, created entrepreneurship programs in Argentina: the IAE, Universidad Torcuato di Tella and the Universidad de San Andrés. The entrepreneurship center at San Andrés was financed by an initial endowment from business angel Francisco de Narvaez. In 1999, entrepreneurship was included as a ‘materia optativa’ in the San Andrés schedule. The program can show some success: Last year 12% of San Andres students became entrepreneurs. The Universidad Nacional de General Sarmiento is also setting up an entrepreneurial initiative and in addition to that is coordinating a comparative study on entrepreneurship in Latin America and Asia.

Polos Tecnologicos

In some of the major cities, including Rosario and Cordoba, technology competence clusters were formed to promote research and development and to facilitate communication. However, facilitation of funding is not provided by these initiatives.

Endeavor

Founded in 1997, Endeavor is a non-profit international development organization with the mission of becoming the leading supporter of entrepreneurship in emerging markets. Endeavor helps emerging-market countries take advantage of entrepreneurial activity by identifying, supporting and promoting the next generation of entrepreneurial leaders in those markets. The organization believes that entrepreneurs are a driving

[74] McDermott (2000), p. 8

force behind innovation and economic prosperity, which is proven by the success of the Endeavor entrepreneurs who have raised over US$900 million in financing and created over 5,000 new jobs in South America. Many of them have also become recognized role models in the South American markets. As a neutral organization, Endeavor is able to bring parties with different interests to one table.[75]

4.1.3.4 Challenges

Possible Default Risk and Interest Rates

Argentine debt is very high and still increasing. Although in July, the government agreed to a plan of minister of economy Domingo Cavallo to cut deficit spending to zero, experts expect that these measures are coming to late to safe the struggling country from default.

Moreover, zero deficit spending will not be enough, as the government also has to pay back and refinance any maturing debt. Because of the high country risk, interest rates paid for this refinanced debt are also increasingly high, placing a huge burden on the economy. In July, Cavallo negotiated the refinancing of the remaining outrunning debt until the end of the year. Therefore, the situation seems under control until that point in time, granted that neither devaluation nor any further decrease of government income destroys these efforts.

Experts agree that the main issue in attacking the high deficit is lowering tax evasion. Sources estimate that the tax evasion of market participants sum up to US$25 billion per year.[76] The tax collection system is very inefficient and tax administration is focusing mainly on large debtors while totally ignoring smaller amounts. Some provinces and city governments have already made successful efforts to privatize the tax collection system, almost always improving their balance.

Recession

The current atmosphere for doing business in Argentina is very negative. Outlooks on the near future are considered negative by almost all market participants, be it investors, professors or startups. The ongoing recession with decreasing GDP, which has been the longest in Argentine history with already 36 months, has brought consumption down and thus limited the possibilities in an already small home market.

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[75] also see http://www.endeavor.org

[76] Source: Emerging Economies (www.emergingeconomies.net)

Many market participants are also very uncertain about the economic policy and development. Changes in regulation, especially in the current environment, occur at a rapid pace, and it is very difficult to adapt to the changes in a timely fashion, let alone forecast them. Thus, long-term projections are almost not possible and planning is very difficult.

With the introduction of Cavallo as minister of economy three months ago, the government tried to stabilize the situation. Although people are listening to Cavallo and most agree that he is the strongest member of cabinet, he has not yet been able to clarify his long-term economic policy and vision. Multiple changes of the tax system have been introduced to improve consumer spending and the competitiveness of Argentine products on the world market, but so far every measure seems only to cure the symptoms of the problems. The regional elections that are coming up in October might give an indication on Cavallo's position in the eyes of the population.

Small Market

The small size of the Argentinean market has severe consequences for the setup of young companies. Because of the limited local market size, niche strategies and specialization are very hard to execute. Companies are not able to focus exclusively on a small part of the value chain, and if they wish to do so they have to have a regional focus, covering several South American markets, thereby inflating operational costs.

The size of startups in Argentina also tends to be small compared to the situation in the U.S. Therefore, startup costs such as legal advice assume a high proportion of the capital provided, which results in a large financial burden and disadvantages for local startups compared to international players. One expert stated that the critical issue is normally not lack of skills but lack of size for local startups, which sometimes prevents good ideas or people from prospering.

Capital Markets and Exit Opportunities

The high level of interest rates leads to a total dry-up of the capital markets. For local investors, the stock market is not very attractive, considering the possibility to invest in high yield government bonds at a relatively low risk. Therefore, the main local investors, pension funds, insurance companies and banks hold more than 80% of their assets in public bonds. "Of particular concern (…) to private equity investors is the continuing lack of liquidity and depth of the Argentine stock market, where (…) 90% of the trading volume is concentrated in five stocks [and the daily trading volume rarely exceeds US$25 million, down from US$100 million per day in 1992/1993]. Vast areas of the economy are not represented at all."[77] Delistings of important and heavily traded companies or the issuance of ADRs in the U.S. let daily trading decline even further. With current returns on public papers, liquidity in the local stock market is not very likely to improve.

As stock markets are highly illiquid, IPOs are generally not considered a viable exit opportunity for venture capital investors. In light of the ongoing crisis, nobody will currently issue stock because valuations are too low and the process would take four to six months, a time span for which forecasting of political, legal or economic developments is simply not possible at the moment. Although a few Argentinean companies, such as ElSitio, were able to successfully complete an IPO on the NASDAQ, this will not be an alternative in the near future as the market environment is too unfavorable.

Consequently, most funds have to rely on strategic sales or consolidation plays for exiting from their investments. However, the potential for strategic sales is also limited. Most investors already consider very concrete possible exit strategies and options when they enter into an investment, and also put increased pressure on their ventures by contract clauses such as drag-alongs and tag-alongs to facilitate exits.

Strong Dollar – Changes in Convertibility

The current strength of the Dollar makes Argentine products increasingly uncompetitive for exports due to the dollar-peso peg. The situation is especially critical because the currency of the largest regional trading partner Brazil has been devaluated significantly at the same time (see 3.2 Assessment of Macroeconomic Environment). In a desperate measure to regain competitiveness and in recognizing the growing importance of the Euro as a world currency, Argentina has recently changed the exchange rate for imports and exports to a 50-50 Dollar-Euro basket, which is in fact a devaluation of the Peso by approximately 8% as the Euro is currently worth less than the Dollar. Foreign trade is now conducted with this new virtual exchange rate, and the balance is deducted from companies' taxes. At the same time, the government announced a complete switch to the Dollar-Euro basket once parity between Euro and Dollar will be reached. From then on, the Argentine Peso will be worth the average of these two currencies.

[77] Latin American Private Equity Review & Outlook 2000/2001, p. 28

This measure implies that the current practice of using the Dollar as de facto payment instrument in day-to-day business (e.g. paying with dollar bills) becomes obsolete. Market participants believe that this change will increase uncertainty because the use of dollar bills generally signals stability. On the other hand, the government is loosening its dependence on the U.S. economy, recognizing the growing importance of the trade with Europe and the European currency in the world markets. Europe already accounts for 18% of Argentina's exports, while NAFTA represents 15%.

Missing Government Involvement

The lack of government support in the creation of young companies is notable and increases the need for a strong venture capital sector. Moreover, the Argentinean government does not effectively facilitate nor foster the environment for startups or a venture capital scene, either. Although Argentina is one of the least regulated economies in the world, its legislation does not truly support small business creation. Some laws are outdated: For example, rigid laws prevent the issuance of stock options, thus companies have to be either incorporated in the U.S. or create costly legal structures to gain access to this instrument.

The tax system is simple compared to the situation in Brazil, as companies only incur six different taxes. Handling of the value added tax (IVA) of 21%, however, is a problem, especially for young startups that have to finance an effective tax credit to the government. The credit is accumulated by purchases from suppliers, and as the young companies in question do not yet have sufficient sales, they need to pay IVA without being able to compensate it against any sales. There is a law pending by which startups can use this tax credit as guarantee for loans, however, the amount will not be available to them in cash, which increases the capital requirements by up to 21%.

Another obstacle to doing business is the still widespread corruption and bureaucracy in the Argentine government and in other administrative institutions.

Entrepreneurial Education and Stigma of Failure

Technical and engineering education is very good in Argentina but entrepreneurial business knowledge is missing in most startups. Entrepreneurial education already has some history in Argentina, but still has to gain a lot of momentum. The efforts of some universities in creating entrepreneurship programs and providing people with the necessary tools are promising steps.

In addition, having failed in creating a company still leaves a strongly negative stigma on Argentinean entrepreneurs. In this respect, the culture is not receptive to the fact that failing can mean a substantial learning experience for the entrepreneur, leading him to avoid mistakes in the future. 45% of Argentineans are afraid that a failure could pose an obstacle to future plans, compared to an average of 37% in the countries covered by the Global Entrepreneurship Monitor.[78]

4.1.3.5 Chances

Macroeconomic Situation

If the peso-dollar peg can be saved and will gain new trustworthiness, it will definitely be a strong advantage to the country. It can attract foreign investors who could safely assume not to incur the exchange rate risk. Secondly, Argentina has a large middle class with the second-highest GDP per capita (PPP) in South America, thereby boasting with a generally strong domestic market. A much higher percentage of the population takes part in the economy than in Brazil, compensating partly for the smaller size of Argentina’s population.

Thirdly, interviewees stated that the level of education, especially in engineering, is good in Argentina and that there are no problems in finding qualified management. Moreover, in the current situation of high unemployment this management can be hired at very low cost. Another factor that influences the availability of good management is the fact that many skilled employees left their former job during the Internet hype to found their own company, and often they have not been able to get back into their previous employment after the NASDAQ correction because of the economic recession. Thus, people with good management skills and startup experience are cheaply available in the market.

At the moment, however, all the positive factors seem totally irrelevant to investors, as most of them are solely concerned about the uncertainty in the market. For this reason, investments are held back until the situation has cleared up, yet nobody can tell how long this process will take.

Only one investor stated that a company’s exposure to country risk depends on its business model. Companies might be exporting most of their goods or services, thereby depending on totally different factors. The situation in the country might drive

[78] Global Entrepreneurship Monitor 2000, Country Report Argentina

down valuations of the companies, which makes investing even more attractive. Thus a general holdback of investments might not be the right way to act in this situation.

Culture

Argentinean culture supports the creation of young companies. Argentineans are open to new opportunities and adopt new trends early, as became obvious during the Internet boom when Argentina had the highest number of startups in South America. In addition to this fact, the high rate of unemployment forces Argentineans to look for new opportunities. In general, Argentineans are less risk-averse than their neighbors in Brazil or Chile.

4.1.4 Outlook

Based on the assessment of the interviewed experts and on our own analysis of the situation, we will present some suggestions on how to improve the environment for venture capital investments in Argentina.

4.1.4.1 Sectors

As the venture capital sector is very young in Argentina and most industries and sectors still contain large inefficiencies, there are many more opportunities to be exploited. Additionally, the economic situation opens these opportunities at a substantially lower cost than in other markets. One expert suggested to use Argentina as a trial country for certain ideas before entering larger markets, as there is much less capital needed to startup a business in Argentina compared to the U.S. or Europe.

Argentina is very strong in creative businesses, therefore Media and Entertainment are promising sectors. Recent examples include De La Guarda and Cuatro Cabezas. Experts are specifically considering content development and the creation and export of formats for example for television shows. As the Argentinean society is very fashion-conscious, investors also look at developing the country into the ‘Italy of South America’ by fostering the design sector.

Because of the high level of engineering knowledge and vast natural resources, interviewees indicated that Argentina has large opportunities for high-growth technology companies in traditional sectors. Specifically agribusiness and forestry in which Endeavor companies Agropool and FincaPilar are active are considered as future sectors of growth. Biotech has not been touched yet but should also be interesting for the future as Argentina is traditionally strong in biological research where it has already won three Nobel Prizes. Another sector that is considered further is tourism, in which Argentina already has created some presence but which is still largely underdeveloped.

As the cost for software development is considerably lower than in developed countries Argentina already has some strong players in this segment, such as Ceicom for Airline solutions and Amtec for e-business. Especially interesting should be the wireless sector because of the strong position in telecommunications.

In general, young companies have to show a model that provides secure revenues and can demonstrate real returns. Investors are also looking for serious and experienced management. Companies' growth projections will not be as high as during 1999/2000, but still reach acceptable levels.

4.1.4.2 Suggestions

It is obvious that the current crisis has to be overcome before the government can turn some of its attention on fostering entrepreneurship and the venture capital sector. Yet, this has to be done eventually because the venture capital scene is crucial in the development of the economy, as already elaborated above. The main problem seems to be political: It is quite clear which measures have to be taken but it is hard to gain the support, as some changes may well be against some individuals' interests.

Improve Macroeconomic Environment and Provide long-term Strategy

The main task to improve the macroeconomic framework for entrepreneurship is to reduce the state deficit, so that the government absorbs less of the available capital, which would reduce the country risk and lead to lower interest rates.

After resolving the immediate problems, politicians have to provide a clear long-term strategy, indicating where the country's economic policy is heading. As venture capital investments have a long-term focus an equally long planning perspective is desperately needed.

Fight Tax Evasion

Fighting tax evasion could be achieved by improving and streamlining the tax administration authorities. Lowering the rate of tax evasion is crucial because it will have two different positive effects on the economy.

On the one hand, higher tax inflows would lower the country's deficit. Every Peso in taxes that is not paid has to be financed by 1US$ of new debt in U.S. dollar by the government, further increasing the dependence on international capital markets. Collecting only part of the estimated US$25 billion of tax evasion could effectively render the need for international financing obsolete. The government has recognized this fact and changed some tax laws to improve the tax evasion problem, but at the same time also introduced tax cuts to increase consumption. It remains to be seen if the total sum of tax-cuts versus new tax inflows turns out to be positive. In any case, privatization of the tax collection system, as successfully shown by several provinces and cities, should also be considered as a viable option.

The fight against tax evasion on a broad scale could also solve a second problem. Today, the attention of tax authorities is still too much focused on the segment of larger tax payments. Smaller amounts are mainly ignored, because it is argued that costs are too high. For many smaller companies that pay their taxes, this attitude results in a competitive disadvantage, as they have problems competing with companies that do not pay and therefore incur lower costs.

Adapt Tax System to the Need of young Companies

Removing the value added tax credit from young companies balance sheets would be a huge improvement for this segment as it reduces capital requirements in the early stage by up to the amount of the IVA (21%).

Also tax incentives for young companies or the venture capital sector are currently not in place but could give a boost to the further development of the sector.

Join Hands with BOVESPA

The most important obstacle to the growth of the venture capital sector is the severe lack of liquidity of capital markets and therefore the lack of IPOs as exit opportunities. Argentina is too small to successfully copy the Brazilian effort of creating a new market to provide this type of exit. The ever-decreasing liquidity of the Buenos Aires Stock Exchange is a result of the fact, that the market is too small and not interesting enough for international investors. This leads to a lack of analysts covering the traded companies, which in turn results into a lack of information and even less trading. Getting out of this death spiral does not seem very likely for Argentina alone.

The only solution for the situation is to create a regional stock exchange to facilitate the access and information process especially for international investors, to increase liquidity and reduce costs.

With the Novo Mercado (compare 4.2.3.5), Brazil has already created an initiative that introduces good corporate governance and accounting principles and much higher transparency and has found widespread approval and interest. Argentina should therefore not go through the same costly and timely process of developing a similar initiative, but the two countries have to make an effort in joining forces to make the initiative regional.

We are aware of the fact that such an initiative would be a highly controversial political and cultural issue. Yet both countries have to consider that the success of a stock market project would give an incredible boost to the local economies in terms of international attention, capital inflows and wealth creation. Both countries can only win from such a joint effort.

Argentina must therefore acknowledge that the Brazilian market is larger and the Brazilian initiative is already developed, therefore Brazil would definitely take the lead and be the location of the new stock market. On the other hand, Brazil has to recognize that a success with Argentine involvement is much more likely as liquidity and attention increases and should therefore not reject an involvement of the smaller neighbor.

Change Attitude of Venture Capitalists

During the Internet hype, venture capitalists were much more of a financial investor than a true advisor. However, most entrepreneurs did not have much experience and did show severe problems in execution. The new generation of fund managers has realized this fact and is using a much more hands-on approach in dealing with their ventures. The process of going through the crisis has educated both fund managers and entrepreneurs. Of both types, today, more experienced people are available and are creating a new class of venture capitalists. Fund managers are also putting increased pressure on the entrepreneurs by strict clauses in the contracts and lower valuations.

The venture capital scene has to be careful, however, not to collect all returns for themselves. In the U.S., venture capital funds have generated a lot of wealth also for the entrepreneurs. So far, in South America that has not been the case. Investors did absorb most of the returns, and the entrepreneurs did not receive the amounts of money that their U.S. counterparts got. This in turn decreases the availability of angel capital from wealthy entrepreneurs and reduces the role model function of entrepreneurs, as the returns are a very important motivation factor for want-to-be founders.

4.1.4.3 Conclusion and Perspectives

"There is no perspective for Argentina, as long as the deficit problem is not attacked."[79] The resolution of the current crisis is the most obvious first step after other problems can be solved. Despite the difficult situation, interviewees see some light: "Most active funds believe that Argentina will get out of the recession in the next 18 months and are preparing for that."

Venture capital is crucial for the development of small companies in Argentina, as debt is not available and the government does not provide other funds. Although most of the investors are very cautious because of the current crisis, the success of a venture capital investment is not necessarily linked to the local macroeconomic development. The individual success always depends on the company risk, which is subject to the degree of exposure to the country development, and the valuation of the company. Thus, funds are mainly focusing on companies that are exporting and are not solely depending on the recession-shaken local market.

As valuations in general are very low at the moment, the current situation seems perfect to make very selective investments in specific industries and business models. After all, it is not called 'risk capital' without reason.

The creation of a regional stock exchange, probably by Argentina joining the Brazilian 'Novo Mercado' effort, could create a liquid stock market and would revive the hopes of investors to be able to exit through an IPO.

[79] Statement of economics expert during the interview

4.2 Brazil

In Brazil, we conducted interviews with 36 individuals, including eight venture capitalists, four private equity players, three incubators, seven startups, two government officials, four professors, two consultants, one stock market official, one lawyer and four other experts.

4.2.1 Economic Overview

With its 166 million inhabitants and an area of 3.27 square miles, Brazil is the world's fifth largest country in size and population and has the largest population in South America. The majority of the population lives in the south-central area, which includes industrial cities such as São Paulo, Rio de Janeiro, and Belo Horizonte. Approximately 80% of the Brazilians now live in urban areas. Rapid growth in the urban population has aided economic development but has also created serious problems for major cities.

Economic Development

Brazil's "miracle years" were in the late 1960s and early 1970s when double-digit annual growth rates were recorded and the structure of the economy underwent rapid change. In the 1980s, however, Brazil's economic performance was poor in comparison to its potential. Annual GDP growth only averaged 1.5% over the period from 1980 to 1993. This reflected the economy's inability to respond to international events in the late 1970s and the 1980s: the second oil shock, increases in international real interest rates, the South American external debt crisis and the ensuing cut-off of foreign credit and foreign direct investment. This lack of responsiveness reflected the largely inward-looking policy orientation that had been in place since the 1960s.

Economic flexibility was further impaired by provisions of the 1988 constitution, which introduced significant rigidities in budgeting and public expenditure. An outcome of these pressures was a steady rise in the rate of inflation, which reached monthly rates of 50% by the middle of 1994. While widespread indexation limited the damage caused by such inflation, it also made reduction of such inflation technically difficult to achieve.

The Real Plan

Important reforms in liberalization of external trade and in developing a framework for privatization were introduced in the early 1990s. Building upon these initiatives, Brazil underwent a major change in economic regime with the introduction of the Real Plan in mid-1994. The Plan's principal goal and achievement was to reduce inflation and inflationary expectations in Brazil in a durable way. It achieved this through a managed exchange rate, de-indexation, structural reform and privatization.

Table 2 - Brazil - Overview of Macroeconomic Data[80]

		1996	1997	1998	1999	2000	2001	2002
Nominal GDP	bn	774.9	807.7	787.9	529.6	587.0f	516.3f	516.7f
GDP per capita		4900	5000	4800	3200	3500f	3000f	3000f
GDP growth (real)	% yoy	2.7	3.3	0.2	0.8	4.5f	2.5f	3.2f
Exports FOB	bn	47.7	53.0	51.1	48.0	55.1f	58.1f	63.1f
Exports	% yoy	2.7	11.0	-3.5	-6.1	14.8f	5.5f	8.5f
Imports FOB	bn	53.3	59.8	57.7	49.2	55.8f	59.4f	64.7f
Imports	% yoy	7.0	12.2	-3.5	-14.7	13.3f	6.5f	9.0f
Trade balance	bn	-5.6	-6.8	-6.6	-1.2	-0.7f	-1.3f	-1.7f
FDI (net)	bn	11.3	17.9	26.1	26.9	30.5f	19.0f	18.0f
Total public debt	% GDP	41.0	41.0	47.5	56.2	56.7f	57.6f	...

Recent years

The results in the area of inflation were dramatic: Annual consumer price inflation dropped sharply to reach an annual rate of only 6% in 2000, as compared to over 2,000% in 1994. This package of measures permitted a resumption of growth, reduction in poverty, and a significant increase in private capital, especially foreign direct investment.

The Real Plan has raised the income of the poor through the elimination of the inflation tax and through higher real wages. Moreover, because of labor market flexibility, price stabilization in Brazil was not accompanied by as large an increase in unemployment as in some other countries in Latin America.[81]

With a per capita income of US$3,500, Brazil still ranks far below Argentina. One reason for that is the unequal income distribution, where two thirds of the population do almost not take part in the economy. With one third being at the brink, redistribution could lead to an increase of roughly 50 million consumers. GDP growth has also been flat in 1998 and 1999 with rates of 0.2% and 0.8% respectively, reflecting the recession in Argentina and has only last year gained speed again with an estimated 4.5%.[82]

[80] Deutsche Bank Research (www.dbresearch.com)

[81] Worldbank Brazil country brief (www.worldbank.org)

[82] Deutsche Bank Research (www.dbresearch.com)

In May this year, Brazil entered into an energy crisis because of its 90% dependence on waterpower and the lack of rainfall. The effect of government measures to fight the crisis on GDP growth is still uncertain. As every entity, be it households or companies, has to lower energy consumption by 20% compared to last year's consumption of the respective month, an already optimized facility may be forced to cut production to reach the target. This in turn might have a negative impact on GDP growth for this year.

Another uncertain factor is the economic development in Argentina. Brazil's export structure is comprised of 19% share to the U.S., 29% to Europe and 13% to Argentina. Although Brazil does not seem to be too dependent on its neighbors' economy on account of its large market size, there exist multiple intertwined connections between these two countries. Additionally, the psychological factor of having an important partner close to collapsing plays an important role.

4.2.2 History of risk Capital in Brazil

The history of modern risk capital in Brazil is quite short. In 1974, the Brazilian development bank, BNDE – Banco Nacional de Desenvolvimento Econômico, created three different entities, IBRASA, EMBRAMEC and FIBASE[83], to take minority stakes in projects that needed risk capital and were not able to get financing on the capital markets. In the private sector on the other hand, some investment companies were founded but without the explicit intention to invest only on a temporary basis in a company. All these efforts were conducted without a legal structure for somewhat like a holding company or partnership.

First Steps

In 1975 a consortium of Brazilian and French businessmen founded Brasilpar, which was intended to be working as a "banque d'affaires". After a restructuring in 1980, Brasilpar in 1981 became the first company to really apply the principle of venture capital in Brazil. However, Brasilpar faced great difficulties in its first years of operation, first because of the economic problems of hyperinflation and recession and second because of the lack of a adequate fiscal and juridical structure.[84] In 1982 CRP (Companhia Riograndense de Participações) started its business and conducted risk capital investments as another pioneer in the Brazilian market.

[83] Investimentos Brasileiros SA, Mecânica Brasileira S.A., Entidades Públicas BNDE

[84] Sorj (2000), p. 25 ff

During the early 1980s various groups became active in trying to promote the sector and create awareness in the business community. These efforts culminated in 1986 in law no. 2,287 designed by entrepreneurs and companies, the securities commission (CVM) and several lawyers that attempted to give a corporate structure and fiscal regulation to the risk capital entities. The law also provided the new companies with fiscal benefits including an exception from the capital gains tax, a heavily discussed issue. Despite the fiscal advantages, all efforts to introduce venture capital to Brazil in this period were doomed because of the difficult political and economical environment. As one interviewee stated: “The 80es were very tough for the venture capital sector because of a lack of capital, bad capital markets and a lack of opportunities”.

In 1988, a new law revoked the fiscal benefits and until 1994 the venture capital sector did not proliferate further. The development bank was still active in the field of small investments into small companies during the 1980s, however it is argued that, as it was acting under political influence, it cannot be counted as a real venture capitalist. At least, BNDES’ efforts kept the hope for the sector alive.

Emergence of a Venture Capital Scene

Finally, in 1994 CVM instruction no. 209 was introduced to the market. The new instruction contained a regulation for the creation of mutual funds for emerging companies (FIEEM – Fundos Mútuos de Investimento em Empresas Emergentes). With the macroeconomic environment evolving from the Real Plan, a new scenario opened for venture capital investors. CVM instruction no. 209 was “very well architected”[85] and introduced a new level of professionalism to the industry.

Emergence of Private Equity

Until the early 1990s, Brazil had been a closed economy with very little competition. With privatization of many state-owned companies and the opening of the country for foreign investments, this had to change, creating a big need for change also in the mindset of the traditional industry and the family owners and thus huge opportunities for private equity investments. In 1995 the first true private equity funds formed in Brazil, mainly driven by local investment banks, like GP Investimentos and Opportunity, and international institutions and private equity players with a lot of experience in this kind of activity.

[85] Sorj (2000), p. 33

Instruction no. 209, however, does only allow investments in companies with revenues of up to RS$ 60 million; therefore private equity players cannot assume the corporate structure of a FIEEM. Actually, until today there is no fitting corporate structure for a private equity fund in Brazil, although the securities commission (CVM) tries to develop a new instruction to change that fact. Consequently, private equity funds in Brazil have to build a highly complex and costly structure in order to be able to undertake the desired investments.

From the 1990s until today, Brazil underwent a huge transformation and private equity investments really flourished. However, exit opportunities were and are still a major concern for investors as capital markets are highly illiquid and not very receptive to new IPOs. Capital markets in the 1990s were only designed for big companies with limited rights for minority shareholders. “The capital market was for bandits”, was the statement of one investor, with transactions performed only within a small network of people. Recent developments to introduce a transparent and clearly regulated new market are attempts to change this fact.

Internet and the Venture Capital Hype

Until 1998, there was no true venture capital in Brazil, but only later stage private equity. By 1997/98, there were about 20 groups engaged in private equity. In 1998/99 and 2000 the success of Internet investments in the U.S. and the great success of companies like StarMedia and ElSitio, which went public on NASDAQ, led to the creation of many small venture capital funds and incubators such as Ideia.com, E-nicial or Notcom.com.

Brazil had a good domestic market, thus venture capitalists, which came mainly from the U.S., instilled a copy & paste philosophy trying everything that had worked in the U.S. This movement led to an influx of funds, which was also spurred by an effort to create SOMA, an electronic market like the NASDAQ for Brazil. Dozens of young Internet startups were created during the second half of 1999 and the first months of 2000. By the end of 1999, the larger private equity firms were also discovering this new segment and started doing venture capital deals, driving up valuations even further.

In 1999 and 2000, many participants flocked the venture capital market in Brazil. As a result, the private equity arm of the development bank (BNDESPAR) decided not to invest: They understand themselves as market makers, providing liquidity when it is lacking. At that time, however, enough money was flowing into the market.

Looking at the NASDAQ

The NASDAQ correction in April 2000 had important implications for the young venture capital sector in Brazil. Not only did it destroy the dream of most venture capital investors to list a company in the U.S., but it also deterred the influx of funds from abroad. As small companies, especially in the Internet space, are very dependent on the continuing inflow of capital until they reach break-even, most of the young startups did not survive. With them also many of the newly created venture capital funds or incubators stopped operations.

As the evolvement of the venture capital sector was mainly driven by opportunistic behavior from investors and entrepreneurs alike, the crash has somehow purified the scene. Most of the applications were just copied and not adapted to local conditions, so they did not have a stable basis.

Today, the situation has changed. The remaining investors are focusing on bringing their existing investments up to speed by getting deeply involved. Cost cutting and restructuring is taking place in many companies. Very few new ventures are invested in. One could call the current efforts a move back to a ‘true’ type of venture capital with a Latin American touch. Some new funds, like Eccelera, have been created after the crash and are showing a very serious approach with highly qualified and experienced management and a very hands-on involvement in their portfolio companies.

New regulation

On March 29, 2001, a new guideline for pension fund investments was passed with *resolução 2,829*. The potential allocation for venture capital has been increased to up to 20% under certain conditions and the new legislation also favors investments that fulfill the rules on improved corporate governance, transparency and accounting as set by the Novo Mercado initiative.

However, as stated above, there is still no law for a corporate structure of private equity funds, although the national association of investment banks (ANBID) has made a proposal to the securities commission (CVM) for the creation of such a regulation.

4.2.3 Current Situation

4.2.3.1 Sources for Financing

Love Money

Money from the four "F", founders, family, friends and fools, or love money does not play a very important role in Brazil. As the private wealth is distributed very unequally, love money is only available to a very small number of people. However, real entrepreneurs are not easily held back by that fact. One interviewed founder recounted that during the early days of his venture he was working during the day earning about US$150 per month, which he almost entirely put into the development of his company, for which he then worked at night.

Debt is not available for young companies in Brazil because of interest rates and lack of collaterals. Also banks are not used to deal with the necessities of startups.

Angel Investments

Individual angel investors are only slowly appearing in Brazil. Traditionally, wealthy Brazilians do invest their money outside the country and have only recently realized the increased potential of investments in this new asset class. In addition one interviewee indicated that they want to stay absolutely anonymous, because of the risk of kidnapping.

Also, many of the family investments in Brazil cannot be classified as true angel investments because they are not managed professionally and are trying to participate too closely in the actual management of the company. In addition, Business angels are not at all organized in Brazil, and there is no equivalent to the U.S. or German Business angel networks. Some Brazilian families are starting to make their investments more professional but in general, the absence of angel money is a big lack for the Brazilian startup scene.

Incubators

Brazil has seen a high number of incubators that have been created over the past ten years. Today there are approximately 135 incubators in the country, mainly initiated and hosted by universities and mainly focused on developing technical applications. Therefore, they differ substantially from the for-profit incubators that have been created in the U.S. during the last five years. Most of the projects in the Brazilian incubators receive initial funding and additional logistical services from the university. However, it has to be underlined that most of these incubators are not self-financing. They receive money either from the universities or from government organizations such as SEBRAE, the department for small and medium enterprises. These incubators are thus publicly financed and not private organizations that are dependent on returns. Nevertheless, the high number of incubators has a very significant impact. In 2000, 1,100 companies were hosted employing around 5,000 people.[86] The head organization for the incubators is called Anprotec[87].

Many public universities, however, still have mindset problems with the concept of investing in private companies. Historically, only research was promoted and funded but the output was not monitored, leaving no incentives for researchers to actually market their projects. In this respect too, the law is changing, to give scientist the possibility to work for private companies part of their time.

Private incubators came following the Internet wave with the traditional U.S. model, but have not been very successful so far, again mainly because of not having professional management and lack of experienced entrepreneurs.

Venture Capital

The Internet hype and the creation of many funds in 1999 and the first half of 2000 created a lot of awareness for this new asset class. The failure of many investments done during these early days did lead to many investors pulling out of the market again but also a purification of the environment.

Today, fund managers are much more educated and experienced in venture capital issues. Investment is no longer driven by opportunistic behavior but is based on solid foundations looking very closely at the management team and the proposed business models. Sound revenue and profit potential is key. Additionally, professionals from larger firms move into the venture capital space. Out of this movement a professional venture capital culture will develop.

The developing sector will look different from its counterparts in the U.S. or Europe in some respects. Today, venture capital participations in Brazil tend to be larger than in other parts of the world, as investors are seeking increased control. Uncertainty and

[86] Figures taken from *Panorama 2000*, Anprotec study

[87] For further information check: www.anprotec.org.br

missing experience of the founders call for a higher involvement of the investor in the company. More work is done together with the startup, leading to a much more hands-on approach of the investor. The downside of venture capitalists taking increased shares in early rounds is that the percentage of equity available for additional rounds of financing is limited and that the founders' share in capital gains is small.

Investors are also putting more pressure on entrepreneurs in terms of contracts. Hardly any contract today is negotiated without a drag-along clause of some kind, reflecting the fact that exit opportunities are very scarce and the investor has to be able to jump on the few opportunities that open up.

A list of currently active venture capital players can be found in Appendix F – Venture Capital and Private Equity Funds.

Private Equity

Most private equity players have retreated from the venture capital space after having invested during the Internet hype and going through the aftermath of the crash. Many investments had to be closed down or are struggling. For the private equity sector the continuous monitoring and management of these small investments is too costly. Especially, because in South America they would have to get much more involved because of missing experience of the management teams. Furthermore, there are still huge opportunities in the traditional sectors for private equity investments.

In Brazil, the private equity sector looks similar to Argentina. Corporate private equity investors like GE Capital operate alongside equity departments of banking institutions, such as Bank of America. Additionally, some large local players have evolved, including GP Investimentos and Opportunity.

Today, private equity investors do not get involved in the venture capital space, but try to use the newly emerging professional venture capital funds as providers for deal flow. This also presents a welcomed exit opportunity for the smaller players.

An overview of private equity players can be found in Appendix F or in the Latin America Private Equity Review & Outlook.

Stock markets

The BOVESPA (Bolsa de Valores de São Paulo) is the most active and somewhat liquid stock market in the region. Still, companies trying to go for an IPO face many obstacles, the most important one being very low valuations. Brazilian companies in general tend to be heavily underpriced, one reason are the limited rights for minority shareholders. As two thirds of a company's capital can be in preferred stocks, the company can be controlled by holding only 17% of the total capital. If a company is sold, limited rights of minority shareholders for example lead to very different prices being paid, in one case US$600 for the voting shares and only US$60 for non-voting. Thus, stocks traded on the BOVESPA in many cases trade below the equity value. The Novo Mercado initiative (see 4.2.3.5) is trying to improve transparency and corporate governance principles.

Government

The Brazilian government is very active in providing funds to both companies and risk capital fund managers. Because it is also fulfilling an educative function and trying to foster local capital markets besides pure investing, the different programs will be described in 4.2.3.3 Initiatives.

4.2.3.2 Sources of Capital for the Funds

Pension Funds

Brazilian pension funds are the most important source of capital for the local markets with approximately 125 billion Reals (US$50 billion)[88] under management. With the new resolution 2,829 passed in March, pension funds are now allowed under certain conditions to invest up to 20% of their assets in risk capital investments. The new legislation also allows them to invest more than the usual 30% for public companies in companies fulfilling the criteria for the different levels of the new corporate governance and accounting practices set by the Novo Mercado regulation (see Appendix E – BOVESPA Admission Rules), specifically 35% in companies fulfilling level 1, 40% for level 2 and 45% for the Novo Mercado level. With the new legislation a huge source of new capital for venture capital is arising.

However, there are still huge obstacles to pension funds investing in the venture capital space.

[88] Latin American Private Equity Analyst, June 2000, p. 3

a. Pension funds are required to present at least returns of IGPM (general price index) + 6%. With long-term interest rates for government bonds still being in the range of 16%-18%, pension funds have only limited incentives to invest in other assets. Interest rates had been going down for quite some time but in light of the Argentina crisis rates are now going up again. As the new legislation does not set any minimum for investments in each category, which would make sense with respect to diversification of the portfolio, pension funds will not be keen to invest until interest rates come down again.

b. The funds have almost no knowledge on investing in the venture capital sector and are also not familiar with due diligence procedures and administrative costs for the venture capital funds. Funds are accustomed to pay only 0,5% to fund administrators without any success fee, compared to 2% plus bonus for a normal venture capital fund.

c. There have been few exits so far in the venture capitals sector, which means that the performance and high returns of the segment are also not proven in Brazil.

Additionally, "as important as the pension funds are as potential sources of capital, their political influence may be even more significant. The largest ones are still state entities, managing retirement funds for companies that in some cases are still owned by the federal or state government. The pension funds could have enormous influence over the Brazilian government's treatment of private equity and other forms of private investing."[89]

Banks and Insurance Companies

Most other local providers of considerable amounts of capital have faced the same situation as the pension funds. The continuing high level of interest rates does not promote asset classes other than government bonds. Additionally, the missing liquidity on the local stock markets lowers the involvement of investors, which then leads into a vicious cycle.

U.S. Capital

The involvement of large players from the United States has historically been strong. The private equity divisions of large banks did initiate the private equity phase in the

[89] Latin American Private Equity Analyst, November 2000, p. 14

early 1990s and they were also deeply involved in the investments made during the Internet hype. However, as exit opportunities are scarce, most of the Brazilian private equity branches have not been able to show considerable returns on the capital invested so far. Therefore, the parent companies in the U.S. are more and more reluctant to put fresh money into the markets and demand the invested money to be recycled and used for new investments.

European Capital

Involvement of Europeans in the venture capital sector has been very low in Brazil. First, this is due to the fact, that the segment is still young in Europe and there are many opportunities left in the home market. Second, the emerging economies to the East are gaining a lot of attention by European players. Third, Europeans are more conservative in their investment behavior and do plan an involvement more carefully.

4.2.3.3 Initiatives

BNDESPAR

BNDESPAR has been created by joining the three initial initiatives from the Brazilian development bank. Today, BNDESPAR is the private equity arm of the bank, and its main goal is the development of the stock market. The organization was created after a World Bank model and receives its funds from BNDES. BNDESPAR started investing in the early 1990s, focusing on the experience the three initiatives had gained in risk capital already since the 1970s. Focusing on long-term investments, BNDESPAR today is holding participations in 65 companies and is investing both directly and indirectly providing funds for funds. Selected administrators, such as Dynamo, are chosen to invest BNDESPAR funds.

Although the main goal is to foster the market for small investments in Brazil, BNDESPAR has realized sound returns in its operations over the last years and is thereby trying to show to the sector that the model can work.

FINEP and the INOVAR Program

In 1999, FINEP - Financiadora de Estudos e Projetos, an arm of the ministry for science and technology, started the Inovar program to address the need for institutionalized action from the Brazilian government to help the development of the venture capital sector and the foundation of startup companies. BNDES has arguably been doing just that, but they are in essence an investing company, whereas FINEP aims to create a framework to foster company foundation.

The Inovar program consists of mainly seven dimensions of action: (1) the website, (2) the venture forums, (3) the network, which currently consists of ~200 institutions, (4) a technological investment facility, which helps investors to make valuations, (5) a venture fund, (6) creating capacity for venture capital by providing training programs and (7) co-financing as credit for investors.

Transaction costs are a big problem for smaller-amount venture capital investments, mainly because of a lack of information. For that reason, FINEP set up a website that aims at providing a service comparable to such websites as moneytree.com or garage.com in the U.S.[90]

FINEP organizes venture forums, where universities, research centers, entrepreneurs and others are invited. After a selection process, the entrepreneurs receive help in developing a sound business plan. At the actual forum, FINEP then tries to initiate the matching between the entrepreneur and investors.

However, some interviewees stated, that the FINEP activities are targeted at companies that already exist and are up and running. The real problem lies in the development of the idea and the creation of the company. As BNDESPAR is already targeting young companies with its programs, FINEP should be focusing on an even earlier stage and try to close the 'innovation capital gap', the step from the pure idea to the creation and inception of the company.

ABCR – Asociação Brasileira de Capital de Risco

The Brazilian Venture Capital Association, Rio de Janeiro, was formed in June 2000 by 26 institutions ranging from fund managers and investment banks to government agencies and universities. Starting as an initiative to support the effort of fostering the local venture capital culture it is representing the funds, which are the only ones to have voting rights, although other members are accepted.

The organization seeks to better educate Brazilian lawmakers about the nature of the venture capital industry, as well as push for specific legislation that would benefit venture capitalists. Another goal is to help to develop the weak capital markets in Brazil, which have created few exiting opportunities for venture investors.

[90] For further information check: www.venturecapital.com.br

Today after only a year of existence, the association already counts 53 members; the large majority of them is private funds. Associated are (1) foreign banking institutions, e.g. ABN Amro, BankBoston, HSBC, JP Morgan, (2) local conglomerates such as GP Investimentos, (3) foreign private equity investors and venture capitalists such as Advent, LatinValley and Latintech and (4) local venture capitalists such as CRP, e-Platform and Stratus.[91]

Brazil Empreendedor

The Brazil Empreendedor program was initially focused on micro enterprises and small and medium sized enterprises, but has been refocused towards risk capital. Being a direct initiative of the presidency, the program shows a commitment and involvement of the highest authorities on the issue of venture capital.

Genesis program by PUC – Rio de Janeiro

Genesis is a region wide program covering all three countries, which starting out of the universities is trying to foster entrepreneurship in the region. The people involved are specifically concerned about closing the ‘innovation capital gap’, the step going from the pure idea into the realization phase by creating a company.

Genesis is especially active in 4 areas:

1. Local research (research component): e.g. on angel investors, on how to develop the perception and information of entrepreneurs on venture capital, on policy strategies to develop venture capital and on exit options
2. Material for teaching (educational component): developing material for students and training material and courses for the venture capital sector
3. Promotional component: organizing meetings to fill the ‘idea gap’ by means of innovation capital or innovation financing[92]
4. Demonstration component: including communication to the public, this initiative also influenced the creation of the INOVAR project.

A specific point of interest at the moment is the study of several governmental initiatives throughout the world on providing incentives for venture capital investing.

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[91] For further information check: www.abcr-venture.com.br

[92] Genesis defines three different kinds of capital: Research capital for R&D, innovation capital for turning the idea into a business and venture capital to drive and develop the business.

Endeavor

The Endeavor initiative is also active in Brazil. For more information on Endeavor, please confer to the description in the section on Argentina (4.1.3.3).

4.2.3.4 Challenges

Capital Markets and Exit options

It has to be underlined - once again - that the lack of exit options is probably the most evident obstacle to venture capital in the region, although the situation for Brazil seems a little more promising than for Argentina. Brazil boasts South America's biggest stock exchange, the BOVESPA, but liquidity on the stock market has dropped to US$400 million of daily trading volume from US$1 billion a few years ago. This is still high compared to about US$25 million of daily trading at Argentina's Merval. Reasons for the decrease in Brazil are the devaluation of the currency, the macroeconomic instability and a tax on financial movements, which increased the trading costs. "While in developed countries, market capitalization is usually well above gross national product, it falls to a fraction of this figure in South America."[93] In Brazil, market capitalization as of June 2001 was US$194 billion with a GDP of approximately US$550 billion. In addition, just 20 heavily traded companies account for 90% of trading and eleven companies make up almost 50% of market capitalization.

The number of newly listed company was also very low during the last years. Today, Brazil has 400-500 publicly traded companies, about the same as 10 years ago. This situation and the low valuations of companies make the IPO exit option unviable also in Brazil.

A lot of potential liquidity lies in the capital of pension funds, insurance companies and local banks. With continuously high interest rates, these do not have incentives to invest in highly volatile and intransparent local stock markets. For the general public, shares have lost credibility due to dealing with minority shareholders in the past. Only 50.000 accounts for stocks are active in Brazil, in the U.S. the figure is 70 million.

Strategic sales are in principal the only viable exit option. Although this type of exit also has been affected by the adverse macroeconomic conditions, because buyers are mainly companies from the U.S. or Europe, once the region pulls out of the crisis, these deals may find increased appeal again. Another potential exit would be the merger with

[93] Latin American Private Equity Review & Outlook 2000/2001, p. 57

a local or international competitor. One investor specifically is looking for a swap of stocks with a strategic partner that plans an IPO in the U.S. or Europe and needs an international branch.

The result of the lack of liquidity and exit options is more drag-along and tag-along clauses. However, courts are still not used to dealing with these terms and structures, which creates a lot of confusion and uncertainty. Trying to deal with the problem investors today are very aggressive about clauses in the contracts.

Regional Macroeconomic Issues

The further development of the macroeconomic development in Brazil boils down to the outcome of the crisis in Argentina. As many leading economist already predict the inevitable default of the country, the crash only seems to be a matter of time. Although the Brazilian economy is not very dependent on its smaller neighbor, most international investors only see the development of the region as a whole, and few actually differentiate.

Thus an Argentinean default would cause an outflow of international money from Brazil, leading to a further devaluation of the Real and higher interest rates. An unfavorable exchange rate would in turn lower returns on investments considerably discouraging international investors further and reducing the inflow of fresh capital, while rising interest rates will provoke local institutional investors to keep investing mainly in government bonds and not looking for different asset classes.

The combination of both would reduce the capital available considerably. It has to be underlined that the dependence on the outcome of the Argentina crisis is more of a psychological nature for Brazil. As exports make up less than 10% of Brazil's GDP (see Table 2) and Argentina accounts only for 13% of Brazil's exports, only about 1% of the total GDP would be affected. But international investors and even most local people connect Brazil psychologically to the development of its neighbor, leading to a self-fulfilling prophecy. Therefore, the exchange rate will drop and interest rates will go up in case of an Argentinean default, but Brazil will probably be able to recover from the setback relatively fast.

“Surprise Risk”

Investors and companies in Brazil face what one interviewee called the “surprise risk”. The volatile environment makes long-term planning extraordinarily difficult. The political decision-making and the impact on the business environment are quite unforeseeable. The current energy crisis in Brazil and the measures taken against it was one good example for unpredictable surprises. The prescribed measures to save 20% energy per participant will certainly lead to a solution of the short-term crisis but will have an uncertain long-term impact on the businesses and the economy as a whole, so investors are especially careful. For a long-term oriented investment strategy such as venture capital, having some certainty about future development is crucial.

The phenomenon in general follows a vicious cycle model: In the absence of planning by other market participants, it becomes impossible to plan for the individual company.

Entrepreneurial Education

Professors in Brazil indicated, that students in general are very interested in the field of entrepreneurship and would like to become entrepreneurs. However, the education in schools and universities does not reflect this desire. While engineering education is traditionally very sound and advanced, the relevant business education for entrepreneurship is still lacking. Because the first universities are just beginning to implement entrepreneurship classes, most would-be entrepreneurs still do not know the basic tools needed for this type of career.

FGV and U.S.P.[94] lead the way in entrepreneurial tracks for business. Subjects include general entrepreneurship, market research in new businesses, the business plan, and financial aspects of new businesses. In Rio de Janeiro, IBMEC provides management education with a more applied approach. The university was bought by two investment bankers that turned it to a model of education similar to the U.S.

Additionally, valuation methods, business plan structures and marketing plans are just a set of tools that can be learned relatively quickly. The basic foundations for entrepreneurial success are laid by the type of learning and working. Still courses are guided solely by the teacher very theoretically and without much student involvement. Taking on responsibility for one’s own development early, working on self-guided projects without much involvement of the professors, learning to negotiate in an early phase are ways of teaching that are still far from being implemented in most universities. Also the teaching body has to rethink the ways of instructing to really give the students a good base for an entrepreneurial career.

[94] Fundação Getulio Vargas, Universidade de São Paulo

The Global Entrepreneurship Monitor reports the highest number of nascent businesses for Brazil in June 2000, however this number is elevated by the large number of micro businesses, that are created mainly for survival. And a report from the Commercial Association of Brazil indicates, that the failure rate of startups in Brazil is 95% in the first year. Failure rates among young entrepreneurs without business experience are extra high, which is not surprising.

Additionally, mainly upper-middle and upper class students are able to receive a sound education in entrepreneurship as they generally have received a good basic education, can afford to attend the best schools and do not have to work in the meantime to finance their studies.

Training of the management pool

"The management pool tends to be underdeveloped for several reasons. First, the mid-tier segment of companies most often targeted by financial sponsors has been dominated by family-owned enterprises, where ownership usually is not separated from management. That has hindered the development of an independent managerial class. Second, many of the most talented and experienced Latin American managers have been enticed by either reasonably secure positions with multinationals based in the region, or by still more lucrative opportunities in developed markets, such as the U.S. and Europe. Third, managers have not been accustomed to equity compensation, though general partners hope to introduce the tactic as a way to align the interests of managers and controlling shareholders."[95]

FINEP and the PUC University in Rio both try to develop and provide managerial education and training on entrepreneurial issues by offering business plan education for founders and valuation education for potential investors.

Stigma of Failure

Entrepreneurial development is also inhibited by cultural issues. After failing with one startup it is very difficult for young founders to get back into employment. In this respect, the situation differs tremendously from the situation in the U.S. In Brazil, recruiters want to see a "success history". Companies also want to hire young people as workers, not as company executives, the mindset of "have-been" entrepreneurs is difficult to integrate.

[95] Latin American Private Equity Review & Outlook 2000/2001, p. 55/56

A failure in the history is also difficult for a serial entrepreneur. One investor indicated, that they would not reference to the CEO for press releases, as his name was related to an earlier company failure. Public relations in this respect have to be handled very carefully.

Regulation

Main regulatory issues include the protection of minority shareholders and intellectual property rights. As the former might be solved by a success of the Novo Mercado initiative, the latter yet has to be tackled. But still, "to opt for a minority stake requires additional due diligence of a company's past, because the financial investor may not have much say over the company's future."[96]

To avoid the difficult handling of intellectual property rights, offshore structures are increasingly common. Companies holding the intellectual property are founded in Delaware or on the Caymans, a development which is very convenient especially for U.S. investors, but very costly to the local company and not very supportive for the development of a venture capital scene in Brazil.

Additionally, "Brazilian companies have more than their share of labor disputes. Brazilian employees commonly file lawsuits to try to make up for what they see as low compensation."[97]

Taxation

Problems in taxation involve both investors and startups. For investors, the application and calculation of the capital gains tax poses a threat to the performance, because "devaluation and inflation are not taken into account when calculating capital gains, and an investment firm could actually lose money during the fiscal year and still pay capital gains taxes."[98]

For young companies the complex tax system itself is posing a huge obstacle. Brazilian companies must pay as many as 56 separate taxes. For a startup company with limited resources it is almost not possible to honor every single tax that it is supposed to. Although most of this tax evasion is not pursued immediately, most companies have

[96] Latin American Private Equity Review & Outlook 2000/2001, p. 56

[97] Latin American Private Equity Review & Outlook 2000/2001, p. 54

[98] Latin American Private Equity Review & Outlook 2000/2001, p. 54

hidden tax contingencies from earlier years, that would surface during a due diligence process and complicate a possible strategic sale.

4.2.3.5 Chances

Many opportunities still untapped

Becoming an open economy only in the beginning of the 1990s and being a developing country, the Brazilian market still provides a vast range of opportunities for serious venture capital investors. On the one hand, the venture capital sector itself is only three years old and has only realized part of its possibilities so far; on the other hand, the Brazilian market is still growing rapidly nurturing the reservoir of opportunities.

The traditional industry is still characterized by oligopolistic structures and huge inefficiencies, leaving space for smaller companies as facilitators or for outsourcing of parts of the value chain. These small companies in turn are in need of equity financing, as debt is not available to them. And most investors today are looking at the market with a broader scope not focusing only on Internet. As one interviewee commented: “Investors perhaps moved too fast during the Internet boom and focused only on the newest technology, but creating an infrastructure is just as important”.

Since last year, investors receive less investment opportunities, instead of 50 to 80 per week it may be only five, however business plans are better elaborated, and the business models are much sounder. Also, the investments are now less expensive because of lower valuations, making investments especially interesting.

Venture Capital becomes serious

After having to go through some painful experience and learning process, the class of venture capitalists and fund managers, which has been evolving after the NASDAQ downturn, is showing a very serious attitude towards investing. On the basis of their previous experience they are now turning to a very hands-on involvement with their ventures with being active in the day-to-day business or even taking on management positions.

To be able to pursue this strategy, many investors are aiming at taking either majority stakes or employ contractual measures to assure increased control of their portfolio companies. Again it has to be underlined that this tendency of taking more equity can also lead to a lack of possibilities for later rounds. By being more involved and working together with the entrepreneur on the development of the company, venture capitalists also perform an education function, as most of the founders do still have little experience in actual executing.

Most of the new Latin-style venture capitalists also have a very close network both local and international. This provides them with contacts to strategic partners in the region, but also with access to international markets and potential strategic buyers.

Novo Mercado

The lack of international liquidity in the local stock markets is mainly a result of missing protection for minority shareholders, lack of transparency and bad corporate governance practices. Also local capital does not flow into the market because of high interest rates and the absence of a local shareholder culture. However, the listing of some Brazilian companies as ADRs in the U.S. shows, that investors generally are willing to buy Brazilian shares, despite the country risk, if access is easy and information is available.

With the introduction of the Novo Mercado initiative, the BOVESPA has taken a huge step towards reviving the dormant stock market in Brazil. The ‘new market’ provides a regulatory framework which contains rules for good corporate governance practices, adoption of U.S. general accounting practices and increased transparency. (see Appendix E – BOVESPA Admission Rules for details on regulation)

Although the regulation is very strict, 27 companies have already communicated their intention to go public in this new segment. “Adopting the U.S. practices will cost companies roughly US$300,000 each…”[99], but companies are hoping for significantly higher valuations because of increased transparency and more rights for minority shareholders. Additionally, BNDESPAR has set up a program that helps companies by covering part of the additional cost.

At the same time BOVESPA is aiming to move companies currently listed on the BOVESPA markets to the new segment. For this matter, two transition levels have been created. Level 1 demands only increased disclosure from companies, while level 2 also introduces additional rights for investors. 15 BOVESPA companies have already entered level 1. Getting companies to level 2 will be more difficult, as majority shareholders are very reluctant to give up some control.

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[99] Latin American Private Equity Analyst, February 2001, p. 4

It is important to notice, that the new market is not intended to be a segment only for smaller companies or companies with a technology focus. BOVESPA's intention is to make the Novo Mercado the future stock exchange for Brazil.

It seems that Microsiga will be the first company to be listed on the Novo Mercado, due to happen in late 2001. "Microsiga is prohibited from disclosing details of its planned offering. But press reports suggest that the company plans to raise approximately 100 million Reals (US$46 million) by selling up to 30% of its shares. Unlike on NASDAQ, the outlook for new listings in Brazil is very promising… there has been a lot of attention and interest being expressed in Microsiga."[100] However, with the uncertain situation in Argentina, Microsiga decided to postpone the IPO, which was originally scheduled for July, until the uncertainty about economic development has been reduced.

A success of the Novo Mercado initiative is absolutely crucial. It could lead to reviving the dry capital markets, attracting international investors and local capital and could provide the desired and long-missed exit opportunity for many risk capital investors. Higher liquidity would also drive up valuations and give traditional companies the incentive to move to the new segment thereby driving up interest from international investors. Several IPOs would free some of the capital bound in private equity and venture capital funds, which would trigger new investments. Funds would also be able to show returns and could attract fresh capital. The boost of a working stock market to the venture capital sector might actually lead to a virtuous cycle, which can be seen in the example of Germany's 'Neuer Markt'.

Additionally, the whole initiative has started a thinking process on corporate governance issues in Brazil.

4.2.4 Outlook

"Brazil has survived the Asian crisis of 1997, the Russian crisis of 1998, the currency devaluation of 1999, so what else should there come that we cannot handle?"[101]

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[100] Latin American Private Equity Analyst, April 2001, p. 4

[101] Investor's answer on the question about his view on the perspectives of venture capital in Brazil

4.2.4.1 Sectors

In the eyes of most investors, the hype sectors e-commerce and Internet will continue to grow, but few new ventures will be financed in the near future in these sectors. Most investors are disillusioned with investments and are only providing add-on financing for existing companies. Investments in the web will mainly come from traditional brick & mortar companies with business models based on actual sales or fees and less on advertising. Internet sales in general are difficult in Brazil, because the country has no history of catalogue selling, thus people are not used to distant buying.

The inefficiencies in many industries, however, open up a big market for smaller companies. Future sectors of growth should be process facilitation, infrastructure etc. Small companies will act as facilitators for big corporations. There is much space for supply chain improvement. The sectors named by investors include infrastructure, services, telecommunications, but many also look for opportunities in traditional industries. Financial services on the web were named several times as a strong future area for investments.

4.2.4.2 Suggestions

Again, we will present some suggestions from the assessment of the interviewed experts and our own analysis of the situation that might help to further establish the venture capital sector in Brazil.

Simplified Tax System

Reducing the burden of 56 different taxes for young companies would not only cut down costs but also improve exit opportunities by making strategic sales easier and more viable. Without the latent contingencies from doing tax payments wrongly or not doing them at all, most companies would be much easier to sell.

Success of the Novo Mercado

The importance of a success of this initiative has to be stressed again. A joint effort of all parties involved has to be made to make this new stock market segment work. A failure of the project probably would kill similar attempts to reactivate the local stock markets for years. A success could have a region-wide effect on other countries joining forces with the Novo Mercado in the creation of a pan-regional exchange. Such a stock market would also lower information costs for international investors, which would result in a higher number of participants and increased involvement in the market leading to higher liquidity.

Monetary and Fiscal Policies

Policies, which will allow for lower real interest rates are also desperately needed. This will not only stimulate investment as access to debt gets available, but also increase the relative appeal of equity-related investment, whether public or private equity, from local institutional investors.

Closing the Innovation Capital Gap

For the deal flow to become of higher volume, more systematic and of higher quality, the innovation capital gap between the idea and the actual foundation of young companies has to be closed.

On the one hand, this can be done by fostering the incubator culture in the universities and by implementing further technology parks. Additionally, universities could be awarded funds not only for research, but also for the creation of companies resulting from this research projects. Universities must overcome the reluctance to support and deal with private companies. Furthermore, entrepreneurial education has to be implemented throughout the whole teaching system, with a focus on more self-responsible work and self-guided projects.

FINEP activities are trying to support the creation of a venture capital sector in Brazil. Additionally, the organization should also focus on educating entrepreneurs to assure quality deal-flow for this new segment.

Increased Influence of the ABCR

The creation of the ABCR has been a huge step forward to creating an influential lobby for the venture capital sector. The fast growth in the number of members underlines the perceived importance of the organization.

Compared to the National Venture Capital Association in the U.S. or the European Private Equity & Venture Capital Association, the influence of the ABCR is still small. The NVCA regularly is heard by Congressional committees on issues and legislation that affect private capital formation. Successes in the lobbying efforts include a central role in the capital gains tax reduction and the 1996 National Securities Markets Improvement Act. In turn, the EVCA, in addition to legal and regulatory advocacy, publishes a Code of Conduct and a Best Practice guideline for members[102], which leads to increased transparency and credibility.

The ABCR is central in joining the today seemingly uncoordinated efforts of the several different organizations and institutions that try to support the venture capital sector. If the association can achieve to present a stringent strategy while at the same time influencing the different initiatives (see 4.2.3.1) to coordinate their efforts, it will create a strong force, which will really help the further development of the venture capital scene in Brazil.

4.2.4.3 Conclusion and Perspectives

In short, the perspectives for the development of the venture capital sector in Brazil are very positive. The large market and still widely inefficient industries provide ample opportunities, entrepreneurial education is starting and fund managers are becoming a lot more professional. The Novo Mercado initiative, if it is successful, could provide the desired exit opportunity.

As venture capital investments are long-term, the current macroeconomic turbulences with the situation in Argentina and the ongoing energy crisis should not be an impediment to the future development of the venture capital sector. However, the government has to increase efforts to make long-term planning easier both for the funds and the companies. This includes the reduction of interest rates and the improvement of the regulatory framework, especially the tax system.

[102] Latin American Private Equity Review & Outlook 2000/2001, p. 75

4.3 Chile

The 21 interviews conducted in Chile included three venture capitalists, one private equity fund manager, two incubators, four startups, two government officials, two lawyers, two professors, two consultants and three other experts.

4.3.1 Economic Overview

With a population of 15.4 million, Chile's market is clearly the smallest of the three countries covered in this study. 75% of the country's population lives in the *Valle Central*, the central valley, where also the country's capital Santiago with its 4.8 million inhabitants is located. Valparaíso with bordering Viña del Mar and Concepción are the most important secondary cities in Chile. The government is currently led by Socialist Party President Ricardo Lagos, who was preceded by a six-year rule of Eduardo Frei from the Christian Democrat Party.

The Chilean economy is centered around businesses based on natural resources. Since the early 1900s, copper has dominated the picture, which today constitutes 50% of all Chilean exports alone. This makes the country especially vulnerable to swings of the copper price. During the leftist administration of Allende in the early 1970s, the Chilean government had taken over large parts of the economy.

Era of the "Chicago Boys"

After the 1973 military coup over the socialist government that brought Augusto Pinochet to power, a group of economists influenced by the University of Chicago, commonly called the "Chicago boys", imposed neo-liberal free market policies on the Chilean economy and thereby set the foundation for ensuing economic growth and an opening to international investors.[103] The first privatizations in Chile were already initiated between 1974 and 1979, mainly in industrial sectors, when the neighbor countries were still not thinking about any privatization efforts. In Chile, a second wave followed between 1985 and 1989, where banks and further industrial groups were made available for sale to private investors.[104]

The beginning of the 1980s also marked the introduction of a progressive pension fund system in Chile, which is based on the capitalization of workers' contributions into the

[103] http://csf.colorado.edu/students/Souther.Sherman/

[104] Agosin, Pastén (2001)

affiliated funds. This initiative is viewed as a successful benchmark example in restructuring a national pension fund system.

The 1990s

For the most part of the 1990s, Chile has prospered from economic growth, with a GDP growth rate of 7%. In 1999, however, the Chilean economy fell into a crisis when the commodity price for copper dropped sharply. Economic growth had already slowed down in 1998 to 3.4% and plunged to -1.1% in 1999. Similarly, unemployment has increased to 10% in 2000, after this rate had oscillated around the 5% level during most of the 1990s.

Table 3 - Chile - Overview of Macroeconomic Data[105]

		1996	1997	1998	1999	2000	2001	2002
Nominal GDP	bn	69	75	73	68	70e	68f	74f
GDP per capita		4760	5150	4930	4500	4600e	4430f	4720f
GDP growth (real)	% yoy	7.4	7.4	3.4	-1.1	5.4e	4.0f	4.7f
Exports	bn	15.4	16.7	14.8	15.6	18.2e	18.4f	20.4f
Exports	% yoy	-3.9	8.2	-11.0	5.3	16.3e	1.3f	10.9f
Imports	bn	16.5	18.2	17.3	14.0	16.7e	17.7f	19.5f
Imports	% yoy	12.7	10.5	-4.8	-19.6	19.9e	6.0f	10.0f
Trade balance	bn	-1.1	-1.6	-2.5	1.7	1.4e	0.7f	0.9f
FDI (net)	bn	3.4	3.4	1.8	4.4	-1.1e	0.0f	0.5f
External debt (gov)	bn	5.2	5.1	5.7	5.8	...	...	...
External debt (gov)	% GDP	7.5	6.8	7.8	8.6	...	...	...

The Chilean economy has undergone a profound change during the 1990s, when family-owned businesses faced the challenge resulting from increased globalization. Many of them sold their business, while others boosted productivity or cooperated with international partners.

As an associate member, Chile has signed a free trade agreement with, but does not form part of, MERCOSUR, the Southern Cone Common Market of Argentina, Brazil, Uruguay and Paraguay, created in 1991. Chile has also entered into separate free trade agreement negotiations with the U.S. and Europe. Apart from deregulation and the lowering of tariffs, the objective of these negotiations is to create awareness for Chile in the international arena. Chile is often only viewed in conjunction with Argentina

[105] Deutsche Bank Research (www.dbresearch.com)

and Brazil, even if the trade volume is not very large (Argentina accounts for only 4% of Chile's total exports). The lack of an independent image of Chile has had a negative effect for attracting investors to the country and increasing exports.

Current Situation

Chile seems to be recovering from its 1999 economic recession, and it is expected that the economy will grow again by 4% in 2001. At the same time, growth rates in the order of 7% as during the past decade seem unlikely for the years to come, given Chile's weak position in the high technology sector. The country's economy is still widely based on traditional sectors and primary goods account for 85% of total exports. The low debt level of the Chilean government and a history of prudent government involvement, however, have earned the country a favorable risk rating, making international capital available at cheaper cost for local firms.

Although today the macroeconomic picture in Chile looks advantageous, the country faces challenges on the microeconomic level. Because of a history without major crisis, Chilean economic culture is much more risk-averse than in neighboring countries, and Chile has achieved its current status by going a relatively secure path with a focus on traditional sectors. This can easily turn out to be a challenge to the country in the light of a rapidly changing global economic environment.

4.3.2 History of Risk Capital in Chile

Today as during the past decades, private venture capital initiatives are few and far between in Chile. At the same time, the Chilean government has taken effective measures to compensate for this deficiency. In particular, the development of venture capital in Chile is closely linked to the history of its pension fund system.

Chile's situation is unique in the way that well-developed institutional investors operate in the market. The cornerstone for this is the existing pension fund system based on individual capitalization, which had been instituted in 1981 in the context of privatizing social security. All Chilean workers are obliged to choose between a set of AFPs ('Administradoras de Fondos de Pensiones', Pension Fund Administrators). 10% of their salary will be saved in a tax-deductible, private retirement fund, managed by the AFP and deposited on an individual account for each worker for the investment in various asset classes.

History of the Pension Funds

During the first half of the1980s, the pension funds had only been allowed to invest in government bonds and Central Bank documents. With the proliferation of investing in mortgages and the Chilean stock exchange, these asset classes were also opened up for the pension funds. Additionally, a regulation was enacted that also allowed investing abroad. At the beginning of the pension fund initiative in 1981, the total amount of funds was US$2.98 billion, which had grown to US$31.15 billion by 1999. This corresponds to an annual return of almost 14%. Between 1981 and 1998, the number of members in the system went from 1.4 million to 5.9 million, or 40% of the entire Chilean population.[106]

Under law N° 18,815, enacted in 1989, the pension funds were also allowed to invest up to 5% of their capital under management into small businesses. As direct investing in this asset class by the pension funds was deemed sub-optimal because of the unique skills required for small-business investing and the large size of the pension funds, a class of new investment vehicle was created. Three different types of such vehicles had been set up: one for real estate (FII – 'Fondos de Inversión Immobiliarios'), for public companies (FIM – 'Fondos de Inversión Mobiliarios'), and for venture capital (FIDE – 'Fondos de Inversión para el Desarrollo de Empresas'). The first FIDE assumed activity in 1991, and currently there are ten FIDE in the market, each disposing of a sum of capital in the US$10 – US$50 million range.

Today, these investment vehicles most strongly characterize the market for investments in young companies in Chile. Particularly the FIDE can therefore be considered to be the foothold of the current Chilean venture capital scene.

Problems of the FIDE

In many cases, however, the FIDE did not yield the expected returns. In some cases, bad investments were chosen, sometimes with bankruptcy cases in the portfolio, while in other instances fraud was mentioned as a reason for failure. In almost all cases, however, the deals were ill structured: FIDE would often not own a majority stake in their investments, and as drag-along rights were a rarely used concept, exiting from investments proved extremely difficult.

[106] *The Washington Times*, by Yilda Olabarrieta, June 28, 2000

Accordingly, after the pension funds had realized low returns from their FIDE investments during 1994-95, they were required to provide extremely detailed documentation to the supervising agency to demonstrate the rationality of their investment decisions. This led to negative mood for further FIDE investments, and as a result, the pension funds refrained from making further investment commitments to the FIDE. Substantial pessimism in the market for investments in small companies arose.

One of the greatest challenges for the FIDE, however, was and in fact still is of regulatory nature. Pension funds are allowed to invest up to 5% of their assets in FIDE, whereas reality shows that only a minute fraction of the allowed amount, more in the order of 1% of the AFP assets, are in fact invested in FIDE. The reason for this is the incentive structure for pension fund managers, which fosters great conservatism. If a pension fund performs more than 2% below the Chilean pension fund average, the respective AFP management company is required to compensate the difference to the average minus the allotted 2%. The logical result of a measurement on the average is that Chilean pension funds all hold the same portfolios. As FIDE investments were unpopular during the mid-1990s, this structure effectively cements the situation where pension funds have dried up as a source of capital for the FIDE.

Consequently, the FIDE currently suffer from severe lack of capital, and in fact only a total of US$300 million has so far been invested in young companies through the FIDE. Money for the FIDE could theoretically also come from life insurance companies, however, these firms are highly risk-averse and mainly concerned with matching duration and providing assets and liabilities in a very long-term approach.

Because of the missing follow-on inflow of capital into the FIDE, most FIDE were not able to diversify their portfolio through more investments. The funds stayed smaller than projected, which resulted in a situation where earlier investments were substantially too big for the total size of the fund. Often single investments were in excess of 40% of the total fund value, which was prohibited and led to legal complications. Apart from the increased risk exposure, FIDE managers became less interested and motivated because they controlled a smaller amount of funds than projected.

Recent Regulatory Changes

Regulation for the FIDE had recently undergone a much-needed change. The three different FIDE classes were abolished and grouped into two, namely publicly and privately owned FIDE, which can both invest in all asset classes, where the pension funds can only invest in the public FIDE. This has effectively increased the transparency of the system and sets the framework for combining the existing capital in less FIDE, thereby allowing the diversification of their portfolios.

Private Venture Capital Initiatives

Before 1999, private venture capital was practically non-existent in Chile. Although the entrance of Ventana Global into the Chilean market in late 1998 was made possible through government support, this instance forms a milestone as the first entrance of a foreign venture capital firm into Chile; the Ventana fund comprised US$30 million. At the same time, the state of the private equity sector was far smaller in Chile than in Argentina or Brazil at the same time, therefore there were no venture capital investments made by these firms, either.

Internet fever never really took hold in Chile, and it was over before it had effectively started. Increased startup activity began in late summer of 1999, and the period ended with the typical Latin-lag of three months in summer of the ensuing year. In particular in comparison to its neighbor Argentina, Chile saw a very limited number of Internet startups. The reason for this is partially cultural and partially based on the economic situation. Argentina, for example, saw still greater economic crisis and higher unemployment in 1999 than Chile, which may have led more Argentineans into entrepreneurial fields, as they did not have as much to lose as their counterparts on the other side of the Andean Cordillera.

One result of this slow Internet activity in Chile is also the almost complete lack of entrepreneurial success in the country. Bazuca and Laborum are probably the most noticed Internet startup still active in Chile together with Gemelo.com and SeNegocia. Bazuca is one of the very few Internet startups in the country to have completed three rounds of financing; it has raised a total of US$6.5 million.

The development of the investment community was correspondingly slow, and only a dozen or so private venture capital funds were set up during this period. Ventana Global and Latinvalley are two examples for venture capital funds in Santiago. Ventana Global has set up a fund that operates as a FIDE and targets investments in the range of US$500,000 to US$3 million in small, privately held Chilean ventures. Also, Ericsson has set up a venture capital fund that focuses exclusively on mobile Internet solutions

(MIFactory). A number of incubators like E-Ventures, Ilatinholdings, or the Universidad of Chile Incubator are now also active in the market.

Target for returns for the existing investments of the remaining venture capital firms can reasonably be expected to lie in the 20% to 25% range in the case of a prudent investing policy.[107]

4.3.3 Current Situation

4.3.3.1 Sources for Financing

Government

The government is the most active supporter of young companies in Chile. As a sizable class of venture capitalists and private equity firms is missing, the different initiatives with government involvement make up most of the risk capital landscape. Details can be found in 4.3.3.3 Initiatives.

Love Money

As the middle class is relatively broad in Chile, many entrepreneurs have been able to find funding from family, friends and fools. This fact is particularly understandable when considering that Chile's entrepreneurs, similar to those from Argentina and Brazil, generally have the same social background, stemming from the upper middle class.

Because of lower interest rates, debt is more available for small companies in Chile. However, commercial banks oftentimes require collateral that young companies cannot provide or are just not used to deal with the demands of startups.

Business Angels

Influential Chilean families have in the past been involved as business angels, often without being aware of the existence of the business angel concept. Access to this capital was in many cases very restrictive and only granted to members or close friends of the respective family circle.

Incubators

The Universidad de Chile has set up an incubator in 1999, which grants access to both students and non-students of the university. Apart from this initiative, there are no other

[107] Source: Interviews with investors of the Chilean venture capital community

non-profit incubators. Ilatinholdings and E-Ventures are two examples of commercial incubators that have been founded during the Internet hype phase. Both provide infrastructure and capital to startups.

Venture Capital

Besides the Ventana Global fund (cf. above), there are now several other venture capital firms in the Chilean market. Latinvalley is one example, which also manages another fund, MIFactory, which is strategically directed by Ericsson and exclusively targets mobile Internet solutions. Moreover, there is a seed capital fund ('Capital Semilla') in Chile, providing funding of up to US$200,000.

Private Equity

Chile lacks a big local private equity company. An equivalent to a GP in Brazil or an Exxel in Argentina is simply not existent, leaving the private equity arena in Chile with a somewhat faceless image. Moreover, it can be argued that the partial success of local private equity groups in Argentina and Brazil has fostered the transition of private equity firms from the U.S. and to a lesser degree also from Europe. This effect has consequently been accordingly smaller in the case of Chile.

As if it was not enough yet, of the private equity players active in the Chilean market only few firms have an office in Santiago. Because of the small size of the Chilean market and the fixed cost to maintain an office there, many private equity investments in Chile are managed out of Buenos Aires.

Stock Market

The Bolsa de Comercio de Santiago is the Chilean stock exchange. While its history reaches back until 1893, these days cannot be counted among its heydays. Today, the Chilean stock exchange, like it's Argentinean neighbor, is largely starved for capital, and many large-cap corporations have left for more liquid stock markets, often as ADRs to the U.S. Also, the stock exchange has not succeeded in establishing a shareholder culture among the Chilean population.

The lack of liquidity on the Chilean stock market, like in Argentina and Brazil, is a challenge for venture vapital in the country. Between 1991 and 1997, there were 44 IPOs in Chile, totaling US$1.16 billion in value. The size of these IPOs was considerable by Chilean standards, with an average size of US$70 million in 1996-97, and they represented a wide array of sectors. In 1997, however, the IPO market in

Chile totally dried up again, owing to the negative effect of the Asian crisis. The last IPO in Chile has taken place in 1997.[108]

At the moment, plans for a second-tier market are under way in Chile to remedy this problem. This initiative has the objective to provide more effective and transparent regulation and listing criteria, similar in its motivation to the Novo Mercado initiative at the São Paulo stock exchange. Despite all good intentions, the chances of success for this initiative seem slim, as the gravity of the stock market's current problems overshadow any optimism among potential investors.

4.3.3.2 Sources of Capital for the Funds

Pension Funds

The US$31.15 billion that the Chilean pension funds had under management in 1999 equal 45% of Chile's GDP. Even a small portion of this sum would theoretically provide significant liquidity to venture capital funds in the country. For regulatory reasons, as discussed above, however, only a minute fraction of this sum is actually invested in these asset classes.

Local Industry Groups

Influential family groups such as the Said, Saez, Ibáñez, Luksic, Andres Navarro and Ricardo Claro control large industrial conglomerates. They provide capital to the risk capital market either in the form of business angels or through participations in existing investment funds.

Foreign Capital

Capital for the Chilean venture capital sector also comes from international sources. Most of the private equity firms active in the market originate from the U.S., from where substantial amounts of their funds are derived. The Inter-American Development Bank (IDB) participates in several funds in Chile, for example in the Ventana Global fund. The IDB invests in Chile through its Multilateral Investment Fund (MIF), which was created in 1993 to encourage the growing role of the private sector in Latin America and the Caribbean.[109]

[108] Celis, C., and Maturana, G. (1998), *Initial Public Offerings in Chile*, in Agosin (2001)

[109] McDermott (2000)

Also, corporate venture capital initiatives can be observed in the market, where capital is also often contributed by international partners. MIFactory with its backing from Ericsson and Saab is one example for this. The CEO of Mexican conglomerate Grupo Carso, Carlos Slim, acquired a 40% participation in ILatin Holdings, a Chilean incubator, at that time worth US$17 million, which also marks an example for the involvement of a foreign player, which was in this instance more clearly driven by an individual than in the previous example.

4.3.3.3 Initiatives

CORFO

CORFO, the Corporación de Fomento de la Producción, is the most prominent government support program for the creation of companies in Chile. Created in 1939, this initiative bore the initial intention to drive industrialization in Chile, which resulted in a high social exposure and accountability for the economic development of the country. During the privatization phase in the late 70s and early 1980s, CORFO sold many of its companies; today it still owns approximately twenty. The agency's policy changed again two years ago: CORFO is no longer investing directly into portfolio companies, but supports investment funds and engages in equity-matching for young companies. Today, CORFO acts as an investment promotion agency, with the aim to make investments more customer-oriented. It is set up as a second level bank, providing funds to entrepreneurs through their respective private banks. CORFO receives its funds from yearly government contributions, from international organizations, namely the IDB, and from the returns of its own portfolio companies

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CORFO has initiated a series of programs to support the economic development[110]. Because of their focus on small and medium sized companies and young ventures, these programs play an important role in the Chilean entrepreneurial landscape. For details see Appendix D - CORFO Programs. Of the ten programs presented, the FONTEC program is the most important for startups, as it is a seed capital fund targeting technology companies with relatively easily obtainable, small capital injections. CORFO is at the time of writing in the process of developing even more new tools for seed funding for Chilean startups.

Moreover, Motorola and CORFO have recently signed an agreement on the installation of a wireless Internet solution center in Valparaíso. This initiative is part of a general

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[110] Gobierno de Chile: CORFO

program to attract foreign high technology investments to Chile, set up by CORFO and the Chilean Committee for Foreign Investments (Comité de Inversiones Extranjeras) in September 2000.[111] Motorola stated that the decision to invest in Valparaíso was based on the excellent conditions in the country for the development of such activities, with the special support of the CORFO program. In the same context, CORFO has also set up an office in Silicon Valley, representing Chile in this technology cluster.

Three years ago, CORFO has conducted a quantitative assessment of the efficacy of its activities. The result was clear-cut: For each dollar that was employed, four dollars flowed back to the government by increased sales and more employment, which had led to increased tax income.

On the negative side, it has been criticized that CORFO's processing is rather slow, and that it provides the largest amounts of its funds only to companies who have already received some funding from private sources, which will then merely be matched by CORFO.

Fundación Chile

Fundación Chile is a privately owned, non-profit organization, founded in 1976 by the Chilean government to foster technology development and innovation in forestry, marine and agribusiness in Chile. It works as a seed capital firm and partners with companies that have technology or markets to offer. An initial endowment of US$50 million from the Chilean government and ITT Corporation has been made as starting capital for Fundación Chile.

Today, Fundación Chile plays an important role in the arena of venture creation in the country and already boasts a track record of successful companies that have been started through their effort. Certifica, an online auditing and certification agency, as a recent and well-noted example, is a spin-off of Fundación Chile and demonstrates the effective involvement of this organization.

Endeavor

Endeavor (see 4.1.3.3) has supported 15 startups in Chile. The organization is currently in a suspension state in this country, although it could have received US$500,000 from both CORFO and from the IDB. Notwithstanding, it did not accept

[111] El Mercurio de Valparaíso, No. 59.684, 2001

the money because the private sector was not willing to contribute to the effort. The future of this initiative in Chile therefore seems unclear, yet because of missing entrepreneurial culture a professional organization helping entrepreneurs is certainly needed.

Other Government Initiatives

The Chilean government has set up several other initiatives with objectives that might not directly be related to the facilitation of financing of startup companies, but that often have a beneficiary effect thereon. Two programs in particular are worth mentioning in this context: Sercotec ('Sercivio de Cooperación Técnica') and Fosis ('Fondo de Solidaridad e Inversión Social'). The first focuses on aiding small and medium sized companies, while the second one attacks poverty. Startups passing through the stage of small and medium sized companies can benefit from the first program, while Fosis provides financial resources for the integration of unemployed workers into the economy, saving startups potential training costs.

4.3.3.4 Challenges

Market Size

Chile's main challenge is the small size of its market. This poses a two-fold problem to the country's economy: Firstly, the small size of its domestic market forces many Chilean companies to expand into foreign markets. During their activity in the Chilean home market, many companies have adopted a broad market approach, as niches are generally too small to provide sustainable business opportunities. The lack of knowledge about niche strategies is often a significant challenge to Chilean companies in their move abroad. And secondly, because of its small size, Chile is often overlooked by foreign companies when considering the South American continent. Particularly in comparison to its neighbors, the Chilean market does often not justify the installation of a separate office.

As a result, Chile has difficulty to differentiate itself from neighboring countries. Chile is often seen as a mere gateway to South America, which leads to a strong dependence on the conditions and performance of Argentina and Brazil. The problematic political environment in Chile's northern neighbor Peru does not aid in promoting the region in the international arena. This problem is largely psychological, as it does not do justice to Chile's sound macroeconomic situation. The Chilean government has assumed the task to promote the country in the international arena by increased presence in technology clusters, e.g. an office in the Silicon Valley, by the attempt to attract a greater number of multinationals and by free trade negotiations with the U.S. and the European Union.

Nonetheless, it remains to be noted that a Chilean company's business may not always be adversely affected by the small market size. Some companies have found good access to international clients, and also have no problem with lacking niche focus because of the nature of their product. Similarly as with country risk in Argentina or Brazil, the exposure a company's business to country size needs to be studied on a case-to-case basis.

Exit Options

Given the lack of liquidity on the Santiago stock exchange and the fact that the last IPO took place in 1997, new IPOs seem out of question in Chile for the near future. Especially for IPOs of second tier companies the market is simply too small. This fact is cemented by the absence of a shareholder culture, which is not surprising in the light of the poor position of minority shareholders in Chile.

This leaves strategic sales as the only viable exit option for investors at the moment. Strategic partners, however, frequently view a private equity investor as a superfluous intermediary. Recently, Exxel has made an exit of a vineyard company. It can be argued, however, that Exxel has sold the company only with the strategic intention to show that exits are possible, as the company plans to raise another fund from limited partners. The vineyard investment was supposedly strong and growing, and Exxel had invested for only two years, whereas normally the company targets an involvement of approximately five years.

Education

Insufficiencies in the field of education affect Chilean venture capital in a twofold manner: On the capital supply side, a lack of qualified fund managers has been a challenge in recent years, and on the capital demand side, poor entrepreneurial training has led to a substantial amount of low quality deal flow for investors.

Basic education and university teaching is generally good in Chile, particularly in technical tracks. At the same time, the Chilean education system appears to be insufficiently geared towards providing entrepreneurial skills. Chile's business schools lack training and knowledge on the professors' side, which in turn reflects on the students. Investors frequently complain about low-quality business plans, poor with regard to professionalism and understanding of the market environment.

At the Universidad Adolfo Ibáñez an entrepreneurship program has been introduced in 1996, but has often not been very effective in its early years. It is one example of a small set of universities in Chile that have embarked on the task to improve education for entrepreneurship. These initiatives have seen increased momentum since the Internet hype era, while they were usually preceded by programs in the field of small and medium sized companies.

Moreover, English skills are low among the Chilean population, especially in comparison to other emerging countries like Thailand or India. The World Almanac & Book of Facts 1998 reports a share of English speakers in the population of only 1.6%, in comparison to 84.3% in Argentina.[112] Although both these numbers seem exaggerated and do not reflect the situation that we encountered in the two countries, they certainly reflect the problem of Chilean businesses in an international context.

Culture

One challenge to venture capital in Chile is of cultural nature: The economic attitude is more risk-averse than in its neighboring countries, with a focus on conservation. This relative lack of entrepreneurial spirit will place a limit on the business opportunities that will be available for participation.

Also, as in Brazil and Argentina alike, there is a strongly negative stigma of failure of an entrepreneur in Chile. A failed entrepreneur will assume risks with regard to his family, society, and his financial position.

4.3.3.5 Chances

Macroeconomic Stability

Chile is a small, but sound market. Per-capita GDP (PPP) in Chile at US$ 12,400 is the highest in South America, and it has not suffered as deeply a crisis during the past three years as Argentina or Brazil. The Chilean government is free of corruption, and there is little tax avoidance. The Chilean Peso is strong and stable. Chile also has a well-developed middle class in South America, and in comparison to other countries in the region, also a high percentage of the population takes part in the economic cycle.

[112] Compare: http://www.kable.com/Newsltr/KDS_Connections/Spring2001/page7sp.asp

This partially compensates for the small population count, as the domestic market is comprised by a higher percentage of the overall population.

With regard to macroeconomics, Chile is the strongest country in South America. “Much as Singapore has been the recent exception to the economic instability in Southeast Asia, Chile has long been the macroeconomic guiding light in Latin America, registering impressive economic growth, moderate to low inflation, and even fiscal budget surpluses throughout the 1990s.”[113]

Its macroeconomic stability should make Chile the premier gateway market for multinational companies into South America. As much as this creates further dependence on its larger neighbors, this puts Chile in an advantageous position, by possibly attracting foreign capital into the market and allowing the country to establish business links to large companies before its neighbors can.

Comparative Advantages of Chile

Chile’s telecommunications industry is among the continent’s strongest. It was privatized in the 1980s, and had thereby very early faced the pressure of international competition. Chile is one of only three countries in the world with a 100% digital network.[114] Also, at 14%, Chile has the highest mobile telephone concentration rate in the region.

The fruit and produce industry, mining and metallurgy, aquaculture, biotechnology, nutrition, and forestry are sectors in which the Chilean economy possesses strong positions because of its natural endowments and past efforts in promoting these sectors. In Chile, the relation of human capital to physical capital is larger than in the U.S. or EU. As many fields of the technological revolution are based on human capital, this might be a chance for Chile to develop a competitive position in the high technology segment, also.

Regulatory Direction

The Chilean government has proven in several instances that it has seemingly understood which direction to take. There will be a reform of the capital markets law, and the creation of a second tier market is also planned, although in a regional context

[113] Latin American Private Equity Review & Outlook 2000/2001, p. 30

[114] ProChile: http://www.chileinfo.com/services/services05.html

it seems wiser to join efforts with the Brazilian initiative. Labor regulation is also on the agenda of Chilean policy makers, the objective is to make it more business-friendly, especially for small and medium sized companies. The Chilean congress has also approved a law that requires that bids designed to acquire the control of a company need to be made through a tender share offer, which ensures that also minority shareholders are offered the same price per share for their holdings.

Cultural issues were often used as excuse for the lack of private venture capital initiatives in Chile. The study of Chilean history has shown, however, that government efforts have effectively compensated the supposed lack of private action, and have paved the way for good economic activity in this country. One can be reasonably optimistic that the regulation currently discussed in the Chilean government will have a similar effect, so it is in the hands of private players to add to this movement.

4.3.4 Outlook

4.3.4.1 Sectors

The Chilean government, mainly through CORFO, has initiated serious attempts to attract high technology talent. Even if these programs will be successful, it will be unlikely that Chile will be a strong future leader in information technology, with the only exception of telecommunications maybe. Instead, Chile is in a good position to couple its sound knowledge in traditional segments with technological concepts imported from abroad. Therefore, the country offers vast opportunities in fields where new technologies are applied in industries such as forestry, mining, aquaculture or agriculture. For the same reason, Chile seems to be in a good position to develop applied biotechnological solutions in these industries. These solutions will mainly stem from the non-genetic biotechnology field.

4.3.4.2 Suggestions

Improve Pension Fund Regulation

Changing the incentive structure for pension fund managers is an overdue step in Chile. Abolishing the assessment of the single fund on the average of the performance of the pension fund sector would allow more creativity in investing. This amendment will lead to more diversified pension fund portfolios, thereby possibly providing the FIDE and young Chilean startup companies with much-needed liquidity. Investments in other asset categories would not necessarily make pension fund holdings more risky, but diversification will even improve the risk-return ratio. Thus, there is still room for loosening regulation, which might lead to increased capital for the venture capital sector. One option to ensure a path to diversification and increasing capital flows to Chilean startups would be to add a floor to pension fund investments in the FIDE, thereby guaranteeing a minimum liquidity.

The pension funds are still not allowed to invest directly in young companies. Because pension funds are the main local sources of capital in Chile, their interdiction to invest directly in later stage but still risky companies effectively kills their own exit option from the investments in FIDE funds that they have already made. With according legislative effort, pension fund capital could be used to provide exit opportunities for FIDE portfolio companies, and thereby often of their own indirect investments. For this to happen, the pension funds must be allowed to invest directly in later stage startup companies, which could again add to diversification.

Abolish Capital Gains Tax

Chile still imposes a capital gains tax of 35%. Foreign company selling shares of publicly listed local firms, however, do no longer have to bear this tax, which has only recently been removed in an effort to increase liquidity on the capital markets. The remaining tax still puts the country in an uncompetitive situation relative to Argentina, Brazil and the U.S. Removing the capital gains tax would give a boost to the private equity and venture capital industry by facilitating exits, as most of the companies that are sold in this sector are not publicly traded. At the same time, abolishing the capital gains tax for local investors would help to create a shareholder culture among the Chileans. At the time of writing, legislative discussion were under way to abolish the capital gains tax, and a positive outcome would certainly help to attract further business to Chile, both by established players and by startups.

Protect Minority Shareholders

The situation of minority shareholders in Chile still needs improvement. Doing away with many outdated practices that favor majority owners is a crucial step in developing a shareholder culture among the Chilean population. This in turn would provide the stock exchange with more liquidity from private individual investors.

This step should go hand-in-hand with a regulation on stock options, as these are not yet covered under Chilean law. Stock options would give the young companies more choice in compensating their employees. However, many people are still not used to receiving equity participations as part of their salary and because many of the young companies will never be public, the upside potential of such a measure is limited.

Work on Culture and Education

Chile is faced with a dilemma because in order for the country to become more entrepreneurial, there need to be a set of role-model entrepreneurs and startup success stories. This would increase the entrepreneurial spirit and consequently investors' readiness to provide capital to the market. On the other hand, however, a role model or success story is only likely to evolve if Chile sees strong entrepreneurial activity over the coming months. Because of this it is highly desirable that a company like Bazuca or Senegocia will be able to expand its business over the coming month.

The advertising agency McKann Ericsson has initiated an advertising campaign calling the population to think positively ("piensa positivo!"). Although the direction of this program is on track, a startup success story will undoubtedly have a much more far-reaching impact than scores of advertising posters calling for optimism.

The programs for entrepreneurship that have been introduced at several universities go into the right direction. They bear the potential to do away with what one interviewee called an education towards being an employee, which currently clearly prevails at many Chilean schools and universities.

4.3.4.3 Conclusion and Perspectives

"Chile has its work cut out for it. Concepts such as natural resource clusters, dynamic competitive advantage, productive linkages, value-added products, whether in marine, agribusiness, forestry or biotechnology capacity, are among the top new priorities."[115] The benefits from Chile's 1980s structural reform, such as privatization, the removal of trade barriers, and deregulation have been earned. Chile now needs to carve out a path that makes use of its comparative advantages.

Chile needs to see the dawn of a new era of private equity investments. The good old times of low-risk and high-returns are certainly over, therefore the largely dormant private sector has to become more active and people have to take more risks. Supported by recent changes in the FIDE regulation, this will then certainly have positive effects on the development of venture capital in the country. Several signs in

[115] *Fundacion Chile*, Annual Report 2000

the market can be interpreted as the beginning of this new era of the private equity industry in Chile, namely the regulatory changes that are taking effect as well as the emergence of new, sophisticated participants in the arena. Many funds have learnt from their failures: Foreign funds will no longer operate at “remote control” but instead show more local presence, and deals will likely be structured better, with majority stakes or drag-alongs.

Venture capital in Chile will be different from the conventional venture capital sector as found in the U.S. or in other South American countries because of the unique economic strengths of the country in traditional fields. Before the background of the relative immature state of venture capital, Chile offers an interesting setting with many opportunities to be exploited. While venture capital may have lost much of its pioneer status in more developed economies, Chile is a case where the role and mode of venture capital yet have to be determined.

5 Latin-style venture capital – A New Model

5.1 The Starting Point

The current situation could well mark the beginning of a new era for venture capital in South America. The NASDAQ downturn and the following spillover of the crash to South America have certainly destroyed some of the confidence in the equity-investing model. Because it occurred so early in the development of the venture capital sector, however, it has also prevented many funds from throwing more money into a market that was not ready for copying the American-style venture capital model. The failure of many funds and companies has initiated a learning process in both the funds and the young companies.

The current restructuring and re-thinking of equity investing means that many of the characteristics of the venture capital sector in this region will still be defined in the years to come. Venture capital in South America will not be what venture capital is in the U.S. or in Europe. Unique idiosyncrasies of the South American economies will mean that also investment firms will have to adopt their market approach.

In all three countries that were considered in this study, the analysis basically boils down to the same conclusion. Capital for young companies is scarce, traditionally, but even more today, as existing venture capital investors are mainly in a wait-and-see attitude and are only making selective, mainly follow-on investments. And international investors are more and more reluctant to throw good money after bad.

But on the other hand, venture capital is extremely crucial for the economic development of the region. Young companies can fuel the growth of the countries, foster innovation and improve the social environment, but only if they have access to low-cost long-term capital. Families can only provide small amounts, business angels are rare and unorganized, government procedures are lengthy and bureaucratic, and debt financing is not an option because of high interest rates and lack of interest from the banks. Thus, venture capital remains the only viable option for startup financing.

Therefore the development of a healthy venture capital sector that is adapted to the local conditions will be an important task in the time to come for all parties involved. Good investment opportunities exist and can potentially fuel the development of venture capital in the region. An increasing number of entrepreneurs understand the need to focus on "bulletproof deals that are much quicker to generate cash flow."[116] Additionally, the withdrawal of many investors that had popped up during the Internet hype period means that valuations are very favorable for investors at the moment.

5.2 Defining Dimensions

The degree and direction by which the evolving South American venture capital sector will be characterized, and by which it also differs from U.S. or European approaches, is determined on a set of dimensions, which will be discussed in the following section.

5.2.1 Strategic Content

It is important to note, that the venture capital and private equity sector in South America so far have failed to prove their business model. Because of missing exits, most funds have not been able to show any financial returns. A few exceptions only underline the general rule and might not even be considerable. Recently, as mentioned earlier, the market saw Exxel selling their vineyard company mainly for the reason of being able to prove the financial performance of the fund. In order to convince investors to supply new capital for a new Exxel fund that is currently set up, they had to show some returns.

The past has already shown the difficulty of a pure financial investment strategy in South America, underlined by the fact that "of the roughly 500 deals completed from 1996 through last June, less than 20 had led to exits."[117] But exits will continue to be scarce in the near future as strategic sales are limited, stock markets cannot be expected to gain liquidity in light of the current crisis, and the Novo Mercado initiative still has to prove its viability. Accordingly, the required investment horizon is much longer in South America than in other, more liquid markets.

Finding limited partners who have only a financial interest when investing in a venture capital fund will be increasingly difficult. Therefore, a fund looking for capital should provide other than pure financial incentives to potential investors and on the other hand, look for investors that are seeking more than pure financial returns.

[116] Latin American Private Equity Review & Outlook 2000/2001, p. 69

[117] Latin American Private Equity Analyst, March 2001, p. 14

This would mean for a venture capital fund to find strategic investors, i.e. companies that provide capital because they are expecting the fund to invest in participations that could be of operational relevance to the respective strategic investor.

Ultimately, also strategic investments are naturally entered into for financial reasons. The concept of a strategic investment differs from purely – or, better put: *directly* financially motivated investments in that the participation in a certain startup may be of even higher value to a company that is active in a related business field than to the public because of the existence of synergies.

A venture capital firm can be able to provide its limited partners with this increased strategic value by focusing a specific fund on a certain industry or sector, which will reflect the strategic interest of the associated limited partners. The venture capital fund as a financial intermediary, on the other side, could even be able to translate this strategic value into financial returns for itself by selling the startup company to a limited partner after the business has proven its viability. This would effectively provide the venture capital firm with a potential opportunity to exit from its investments without relying on an outside investor for a trade sale or the stock market for an IPO.

5.2.2 European versus U.S. Capital

European involvement on the investor side in South America has historically been low. Capital inflow was limited to several large acquisitions of telecommunications or utility companies by mainly Southern European conglomerates, such as Telefonica from Spain, or the setup of some subsidiaries by large chemical or automotive players. But European companies have been acting on a very small scale in the private equity or venture capital arena.

One reason for this fact is clearly geography and the distraction by other market opportunities. Since the period when the South American continent became particularly interesting for investors, i.e. during the 1990s, (see 3.3), European companies had (and still have) to realize large potential in their own markets. Additionally, they have vast opportunities at their doorstep, namely through the opening of Eastern European economies. South America is therefore competing for European money also with the emerging markets of Eastern Europe, which have the advantage of immediate vicinity.

Also, the decision process for investments is longer, more conservative, and more bureaucratic in European companies compared to their U.S. counterparts. While U.S.

companies tend to react very quickly to perceived opportunities, European corporations are sometimes hindered even by political issues, because of continuing state participation in many big firms.

However, the presence of subsidiaries of European companies in many of the South American countries, in areas such as telecommunications, chemical industry, automotive, and banking, shows the continued interest of European players in an involvement in the local markets. The current situation also shows, that Europeans have more of an interest in long-term strategic involvement in South America as their U.S. counterparts. U.S. investors have by tendency had shorter investment horizons and were more focused on pure financial returns of their investments.

For these reasons, adding European companies as strategic investors to a Latin-style venture capital fund could potentially combine two seemingly distant interests. Leveraging the strategic involvement of European companies to the venture capital sector, as investors with an additional strategic intention would also provide venture capital firms acting in the region with a broader international network. Ties between the two American continents have historically been stronger than with Europe, and therefore the inclusion of European players could mean access to new strategic partners and easier access to export markets on both sides.

5.2.3 Regional-but-Local Approach

An industry or segment focus is a prerequisite for a venture capital fund trying to attract strategic investors. Because of the small market size of most of the South American markets, a venture capital fund covering a specific sector has to be regional. One country is just not enough to provide sufficient deal flow, even Brazil does not offer enough high-quality opportunities for a focused fund.

Additionally, a regional approach leads to in-depth coverage of the development of the specific sector in South America with more information about competition and especially alternative investment opportunities.

However at the same time, venture capital in South America must respond to local characteristics. Vast differences in the local markets, different regulatory and legal frameworks and a diverse cultural environment require a profound knowledge of each market. Access to local networks is another prerequisite for the success of a venture capital fund, be it for strategic partnerships, financing or to avoid long bureaucratic procedures. As business networks are very tight in South American countries, access is extremely difficult for outsiders. All these peculiarities of the different markets lead to the conclusion that a strategic venture capital fund has to be present in each major country with experienced local management.

Although this multiplies operational costs for the fund, we consider the 'regional-but-local' approach crucial for the success of the Latin-style venture capital model. To cover the costs by management fees from a fund of significant size, a fund managing company could even set up two or three funds for different industries. The fund managers would not need too much in-depth industry knowledge, as part of the due diligence process can be 'outsourced' to the strategic partners. For the setup of offices in three countries, we estimate the operating costs per year to amount to US$1.5 million dollars, which leads to a necessary fund size of US$75 million assuming a 2% management fee.

5.2.4 Management

Involvement

The experience from many badly performing deals during the Internet boom shows, that hands-on involvement from the venture capitalists is often required in South America. As entrepreneurial education is just starting and there are still only few serial entrepreneurs, many founders are lacking the necessary skills to successfully lead a company. Especially investors complain about poor execution skills. Which does not mean, that the quality of entrepreneurs in South America is bad, they are just lacking the experience of their U.S. or recently also European counterparts.

The increased involvement in the day-to-day business demands multiple skills from the future managers of venture capital funds in South America. On one side, they need to be able to manage the investment fund and to play the role as a financial intermediary. The fact that in the past many fund managers came from buyout backgrounds, often with investment banking experience[118], was good in this regard, but not enough.

Because additionally, fund managers are required to exhibit operative knowledge in the field of early-stage, mainly technology-focused investments. All of the recently created venture capitalists, such as Pegasus in Argentina or Eccelera in Brazil, have at least one or two managing partners that have at least once actively managed a startup.

[118] Latin American Private Equity Review & Outlook 2000/2001, p.71

Given the unstable background of the South American economies combined with the volatile startup environment, this experience proves to be incredibly valuable especially for a South American fund. As one interviewee stated: “Internet in South America – it doesn’t get much riskier than that.”

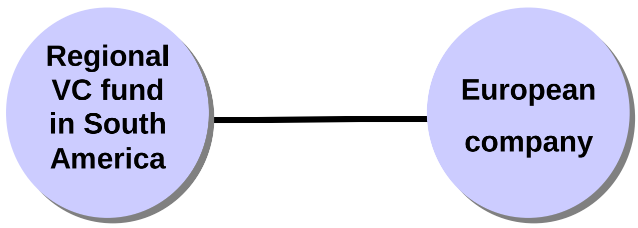
5.3 A Possible Venture Capital Setup

Rather than providing the *one right model* for venture capital in South America, the following section aims to present what we reckon to be a *possible* setup of such an investment fund, taking into consideration the history of risk capital in South America and responding to the difficulties and idiosyncrasies of the market as presented above.

5.3.1 Organizational Structure

For the reasons elaborated above, the Latin-style venture capital model aims at attracting companies with a strategic focus as limited partners to invest in a regional venture capital fund with a specific industry or sector focus. Because of their mainly strategic interest in the region and their limited involvement as investors up to this point, these companies would be looked for primarily in Europe.

Both parties would benefit from this structure in the following way:



<u>Providing</u>	<u>Providing</u>
VC knowledge of management	Access to capital
Knowledge of local environment	International network
Access to local network	Industry knowledge
Hands-on approach in investing	Strategic partnership
	Potential exit
<u>Realizing</u>	<u>Realizing</u>
Management Fee	Presence in South America
Returns from VC investment	Access to local strategic partners
Increased international contacts	Revenue potential from VC investment
	R&D

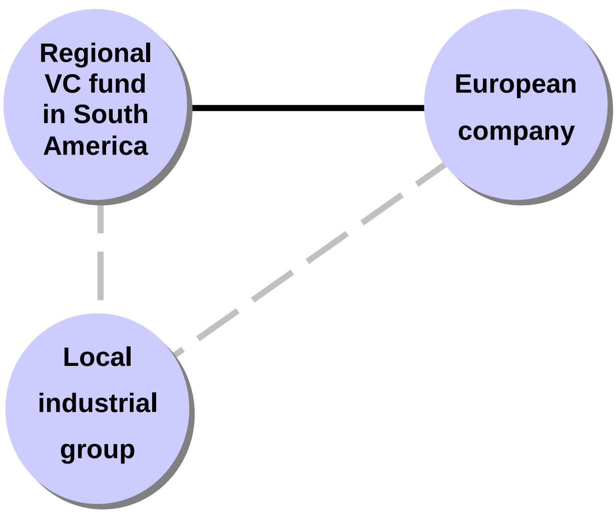
The investment fund would have a regional scope to tap into the business opportunities in Argentina, Brazil, Chile and eventually other South American countries, thereby improving the quality of deals. Probably Mexico must also be included early on, but as this country is not included in the study, we cannot assess it any further.

For the strategic partners the involvement can also be regarded as a kind of outsourcing of Research and Development as they indirectly provide funds to the development of new technologies or business concepts. Many big pharmaceutical companies are already successfully applying the concept. However, in this case the process is not feasible without an intermediary, the venture capital fund, providing local market knowledge and access to the local network.

5.3.2 Cooperation with Industry Groups

An additional component which would certainly further strengthen the setup of the Latin-style venture capital fund would be a cooperation with one of the local industry conglomerates. Family businesses are still extremely strong in South America, but most of them have not yet found the way into a professional form of venture investing, exceptions include the Said Group and Grupo Clarin in Chile or the Bemberg family in Argentina. Several individuals from the family groups have been active as Business angels in the past, thus money and awareness seem to be present. Maybe companies have just not found the right investment vehicle yet.

A cooperation of the fund with local industry groups could provide increased access to networks in the respective countries and also the link into traditional industries and segments, which may be needed as strategic partners.



Such an involvement would mean for the local group:

<u>Providing</u>
Local network and access to markets
Strategic partnership
Industry knowledge
<u>Realizing</u>
Strengthened position in home market
Revenue potential
Access to international markets

5.3.3 Type of Business Concepts

Business concepts that will be successful in South America will to a lesser extend be "me-too" companies than in the past. "While the majority of pre-correction Internet investments in the region were largely 'copycat' business plans derived from examples in the U.S. and other developed markets, recent investments have reflected a greater cognizance of the region's own characteristics"[119] with a higher degree of customization to the local economic, technological and cultural contexts.

The Latin American Private Equity Review even goes so far as to doubt if many of the past investments in South American startups have been "true venture capital, in the sense of initiating long-term business value creation. Rather, a large number of these investments have been opportunistic arbitrage plays on the once-seemingly insatiable appetite of public market investors for an equity piece of the new economy. That era, however, now seems behind us."[120]

Therefore, future business concepts have to offer sound business models and true potential for revenues. Companies must be focused on growth and stability, not on a speculative play with the aim of short-term financial gains. Additionally, the social impact by job and wealth creation is especially important in the South American context to let these companies become a driving force in the economic development of the countries.

5.3.4 Segments

There are several sectors in South America where a setup such as our Latin-style venture capital model seems feasible. Exemplifying we will name three possible industries and sectors, which interviewed fund managers have recognized as interesting for the future.

Telecommunications

The telecommunications sector is viewed by many as a fertile future market in all of Latin America. Privatization and greater competition are spurring growth in spending on telecommunications services and equipment. The estimated 60 million main telephone lines in Latin America will surpass 80 million in 2003, meaning an increase in

[119] Latin American Private Equity Review & Outlook 2000/2001, p. 71

[120] Latin American Private Equity Review & Outlook 2000/2001, p. 71

teledensity from 12% to 16%.[121] Increased use of telecommunications is driving demand for cutting-edge telecommunications technologies. Because of early efforts in privatization Chile's telecommunications market is the region's most liberalized. "Investments in Chile's telecommunications sector are projected to run about US$700 million annually as the market grows an average 14% per year."[122]

Apart from successful privatization programs in the fixed line segment, cellular phone technology is frequently viewed "as a solution to the twin obstacles of relatively low fixed-line and computer penetration."[123] Equally important, there is expected to be greater competition in the wireless markets, due to two factors. Government is expected to continue to auction wireless licenses, while the formerly state-run monopolies are expected to have substantially less incumbent power in the battle between wireless and fixed-line telephony. Therefore, the wireless sector has grown strongly in most countries in Latin America, "in some areas, such as Rio de Janeiro… the number of wireless lines already exceeds fixed lines, and other areas also will quickly achieve that distinction."[124]

Setting up a venture capital fund with the involvement of some advanced European telecommunications companies for example for the development of applications for the growing South American telecommunications market or for the development and testing of new technologies in young startup companies seems to be a promising perspective. Actually, the Ericsson involvement in the MIFactory fund in Chile aims at exactly that, the development of applications for wireless Internet.

Financial Services

The sector for financial services in the South American region still offers immense opportunities for small facilitators with a technology solution. With many inefficiencies still existent in the traditional banking system, as seen by the practice to transfer money from one person to the other by physically sending a check, online banking solutions are still widely unknown or excessively tedious.

Also other areas like solutions for corporate clients or credit rating software are areas of interest for young companies. One startup we visited had programmed a solution for

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[121] ExportIT Latin America, p. 10

[122] ExportIT Latin America, p. 11

[123] Latin American Private Equity Review & Outlook 2000/2001, p. 64

[124] ExportIT Latin America, p. 12

the tracing and control of loans given by the bank to small and medium sized enterprises. Being currently reviewed by the banking association, the product showed some significant potential in a market, where banks are in many cases not able to control the usage of the money lent to the company.

A fund focused on financial services could be founded with the participation of major banks providing in-depth industry knowledge and strategic guidance and profiting from the new technologies developed by the portfolio companies.

Agribusiness

Especially the field of technology application to sectors where Argentina, Brazil and Chile have historically been strong can yield lucrative business opportunities. Forestry, agriculture or aquaculture are fields that can be considered in this regard.

In these fields the development of new technologies to make processes more efficient or increase output could increase not only the revenues of local industries but innovations could also be exported to other countries. This in turn would reduce the dependence of the South American countries on the primary sector, especially in the case of Chile.

Strategic partners investing in such a fund could come from the chemical industry but also food processors or pharmaceutical companies could be interested in this field.

6 Conclusion

Venture capital investing is a very recent phenomenon in South America, having started merely three years ago, and despite its young history, the sector already had to go through turbulent times. The developments during the last twelve months were definitely a setback but also initiated a very healthy purification and re-thinking process. Many investors now realize that venture capital in South America has to be adapted to the local conditions and will look differently than in the U.S. or Europe.

Because of the specific situation in the South American countries, however, venture capital is also crucial for the economic development in the region, for innovation, employment and wealth creation.

Each of the three countries studied offers a wide array of opportunities for venture capital investing, coupled with obstacles that cause investors to act extremely carefully. The future for investments of venture capital and private equity in the region will therefore largely depend on the degree to which these obstacles can be dealt with.

In the case of Chile, the main problem is its small market size, which is a factor that will not change in the future. Success of startups and therefore the availability of opportunities for equity investors will require the ability to adopt regional strategies and rely on export businesses. Chile's characteristics with comparative advantages in fields such as forestry, mining or agriculture, may allow the implementation of such business models. Opportunities for venture capital and private equity investors might more precisely be found in related fields to these industries, such as biotechnology and software that provide business solutions to companies in the industries mentioned above.

In the case of Argentina, the main problem is the high debt of the country coupled with its inability to borrow more from other countries. This situation puts the dollar peg at risk, putting most investors, foreign or local, into a wait-and-see position. Further foreign investments into Argentina seem unlikely until the dollar peg is either safe beyond doubt and guaranteed by economic fundamentals or until the peso is devaluated. However, venture capital investors may still be able to take advantage of the fact that valuations are very low at the moment. Selected investments in companies that are likely to be less affected by devaluation, i.e. because of reliance on exports, might prove very profitable once the country is going back to normal.

In the case of Brazil, the main problem at first sight seems to be the prevailing energy crisis. On a more profound level, this adverse situation as well as many of the difficulties usually associated with this country stem from a very volatile political and economic environment in which long-term planning is extremely difficult. This characteristic requires local fund management who can deal with this uncertainty and can transfer this ability to the portfolio companies, while remote-control involvement seems little promising. Brazil's market size in any case does make the country the obvious first choice for venture capitalist involvement in South America.

The proposed setup for a Latin-style venture capital model may be a way to overcome at least some of the multiple obstacles that this investment category is still facing today in South America. In any case, it will increase awareness and the knowledge of the local situation abroad through the involvement of international players.

Lack of information on venture capital issues, both abroad but also in the local environment, has been one of the obstacles that has hindered the growth of the sector up to this point. We hope that this study will close part of this information gap and educate on the specific peculiarities of venture capital in South America. Future areas of research could be an in-depth analysis of the stock markets and a framework to create a shareholder culture in the South American markets. The situation of business angels and their impact in a society with scarce capital resources or the development of flourishing regional competence or technology clusters outside the large South American mega-cities to stop the emigration wave from rural areas would be other interesting questions to answer.

If in the future some of the suggestions indicated by this study are realized and some of the obstacles removed, "venture capital may well take hold and spread in a region that has long been starved of long-term capital, and often short of investors willing to back smaller enterprises based on potential business value rather than the quality of collateral or personal connections."[125]

[125] Latin American Private Equity Review & Outlook 2000/2001, p. 71

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Appendix A – Interview Agenda

The following topics were at least touched on in all of the interviews.

- **Risk Capital Sector**
  - History of venture capital and private equity in the country?
  - What is the current situation for investors?
  - Where are the main problems?
  - What are potential opportunities for the country?
  - What might the future development look like:
    - Who will invest?
    - Which sectors might be most promising?
- **Startup-Scene**
  - What is the current state of Entrepreneurship in the country?
  - How did the startup scene develop?
  - Which are the main obstacles faced by entrepreneurs?
- **Government Involvement**
  - Which initiatives does the government take to help entrepreneurs and / or investors?
  - Should the government even be involved with state programs or should it only pave the road by changing regulation and giving incentives?
  - Which changes / regulations should be put in place to foster the industry?
  - What other initiatives, apart from the government, are taken to help young entrepreneurs and investors?
- **Macroeconomic Conditions**
  - What does the macroeconomic environment look like?
  - Which specific macroeconomic risks do investors / entrepreneurs face in the country?
  - How do macroeconomics influence the development of venture capital?
- **Specific Data**
  - Fund size and investments, current and future sectors, expected IRR, average time of investment, average acquired percentage, average investment volume, deal flow, syndication, involvement in companies, added value

Appendix B – Interview List

Argentina

Carlos Adamo, CEO
PCP Inversiones S.A.

Roberto Alemann, Former Minister of Economy and Argentine Ambassador to the U.S.
Argentinisches Tageblatt

Sebastián Bellagamba, Vice President for ISP
CABASE

Fernando Branca, CEO
Youstartup Incubator

Lisandro Bril, CEO
Holdinvest

Luis María Brunelli, Senior Investment Banker
Boston Investment Group

Juan E. Cambiaso, Socio
Marval, O'Farrell & Mairal

Alberto Cavallo, President & CEO
Digicuenta

Peter Davenport, CEO
BISA

Matías M. Galarce, Investment Professional
Softbank

Ernesto Galindez, Founder and Partner
TGV IT Consulting

Federico Galvan, PhD Student
IAE University

Osvaldo Gimenez, Country Manager
Mercado Libre

Gabriel H. Jacobsohn, Professor for Entrepreneurship
San Andres University

Hugo Kantis, Professor, Coordinator of IADB study
Universidad Nacional de General Sarmiento

Ricardo J. Lalor, President
Buenos Aires Capital Partners

Pablo Munizaga, CEO
Latinpago

Karl Ostenrieder, Former Director for Argentina
Deutsche Bank

Alec Oxenford, CEO
Deremate

Mario Quintana, Managing Partner
Pegasus venture capital

Diego Rosner, Account Manager
Salutia

Ignacio Sniechowski, Senior Analyst
Boston Investment Group

Andres Sommer, Associate
Merchant Bankers Associados

Gala Tonconogy, Entrepreneurship Services Manager
Endeavor

Alberto Viera Basso, Managing Director
Buenos Aires Capital Partners

Diego Vilan, Consultant
Roland Berger Strategy Consultants

Brazil

Veronica Allende Serra, Managing Director
International Real Returns LLC

Tales Andreassi, Professor for Management
FGV

Estella Araujo Penna, Director
BNDESPAR

Wilfredo R. Arredondo, Director of Marketing
Papel Virtual

Jorge de P.C. Avila, Director
FINEP

Daniel Baranowski, Associate
Bain & Company

Robert E. Binder, Director
ABCR

Andre Burger, Managing Director
CRP Investimentos

Luciano Conçalves de Oliveira, Consultant
Roland Berger Strategy Consultants

Daniela Didier, Marketing Associate
PUC Rio Incubator

William Eid, Professor for Management
FGV

Roberto Engels, Principal
Bank of America

Eduardo Giuliani, CEO
Venture Partners do Brasil

Erico Guizzo, Reporter
Exame Magazine

Eduardo Grytz, Associate
BancBoston Capital

Karl Hirtreiter, Director
Volkswagen AG

José Jiménez, Commercial Manager
E-Financial / Banco Santos

Rodrigo Leite, Business Director
Eccelera

Roberto Malta, Director
Bondfaro

Pedro Mello, CEO
Nexxy Capital

Priscila Pereira Rodrigues, Associate
International Real Returns LLC

Marco José Perlman, Officer
GP Investimentos

José Antonio Pimenta-Bueno, Professor
PUC Rio

Mark Pinheiro, Associate
Latinventure

Sérvio Tulio Prado, Professor for Management
FGV

Romero Rodriguez, CEO
Buscapé

Ricardo Russo C. de Souza, Internet Director
E-Financial / Banco Santos

Erwin-Theodor Russel, Director
Advent International

Charlotta Rutz, Associate
E-nicial

Sergio Sacchi, Vice President for Sales and Marketing
Notcom

Adriana P. Sanchez, Listings and Business Development
BOVESPA – São Paulo Stock Exchange

Patrícia Silberberg, Founder
Fulano.com

Pablo Sorj, Associate
Mattos Filho

Marcos Wettreich, CEO
Ibest

Bob Wollheim, CEO
Ideia.com

Makoto Yoko, Venture Associate
Endeavor

Chile

Alvaro Alliende Edwards, General Manager
Ventana Global

Leopoldo Arias Bolzmann, Professor
Universidad Adolfo Ibáñez

Alfonso Arancibia Sánchez, Executive Director
BTG Trust

Ruth Bradley, Correspondent, LA Private Equity Analyst
Asset Alternatives Inc

Juan Braun Ll., CEO
E-Ventures

Guillermo Carey, Lawyer
Carey y Cia Ltda.

Alicia Castillo Holley, General Manager
Capital Semilla

Roberto Darrigrandi Undurraga, Director MBA Santiago
Universidad de Desarollo

Michele Golodetz, General Manager
Fundacion Chile

Germán Heufemann Lara, Gerente de Operaciones
BTG Trust

Juan Ignacio Parot, Managing Director
Latinvalley

Ximena Jimenez, Associate
McKinsey & Company

Gonzalo Jimenez Seminario, Executive Director
Proteus Consulting

Alberto Libedinsky S., Founder and former Manager of Estrella Americana FIDE Fund
International Links

Adolfo López, Founder and Director
CrossRoads Ltda.

Alfonso Molina, MBA Student
Universidad Adolfo Ibáñez

Christian Moreno T., High Technology Investment Manager
CORFO

Santiago Muzzo, Founder
Bazuca

Alfredo Sfeir, Former Managing Director
Endeavor

Salvador Valdes C., Lawyer
Carey y Cia Ltda.

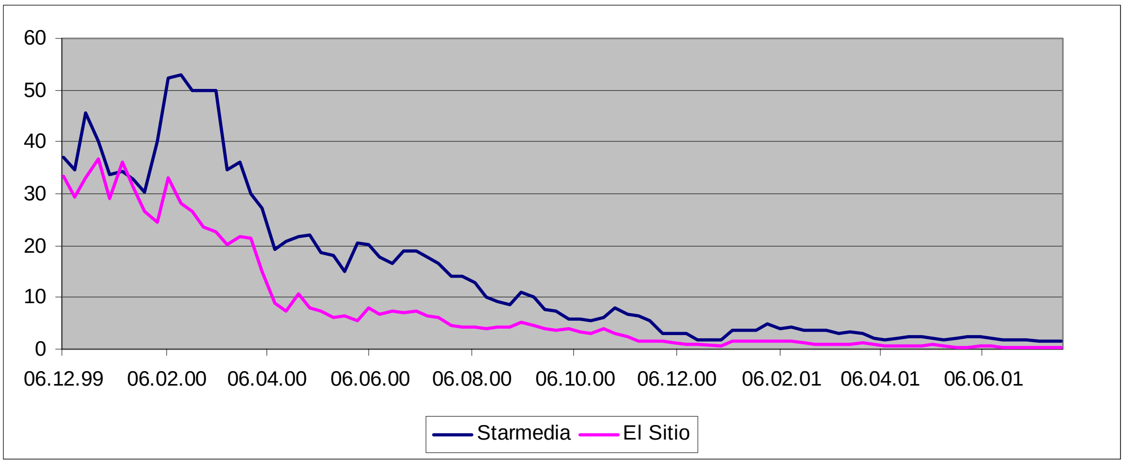
Alex Visic, Founder and Director
University of Chile Incubator

U.S.A

Tom Eddy, COO
Atlas Ventures

Susana García-Robles, Director
Multilateral Investment Fund (MIF) of the Inter-American Development Bank

Appendix C – StarMedia and ElSitio Share Prices



Appendix D - CORFO Programs

1. Intermediación Financiera: In this program, CORFO helps small and medium sized companies to access capital sources by providing limited lines of credit and securities for the acquisition of funds from third parties.
2. FONTEC: ("Fondo Nacional de Desarollo Tecnológico y Productivo"): This is a national technology fund of US$20M providing seed capital to small startup companies. An investment committee, assembling every 15 days, approves grants to the applicants, who, once approved, do not have to pay back the grant. The grants typically range from US$50,000 to US$100,000.
3. FDI ("Fondo de Desarrollo e Innovación"): CORFO aims to foster innovation and technological development in socially desirable fields through contests in companies and other technological institutions.
4. PDP ("Programa de Desarrollo de Proveedores"): The objective of this program is the improvement the cooperation between a small company and its suppliers. Credit is granted for improving the efficiency of these vertical relationships.
5. PAG ("Programa de Apoyo a la Gestión de Emrpesas"): This program provides help on the way to a professional management by financing training and seminars to this end.
6. TodoChile ("Programa de Promoción de Inversión Privada en Regiones"): Especially given Chile's geography, this program fosters regional development in the provinces of the country.
7. PTI ("Programas Territoriales Integrados): This is a regional development program by CORFO to improve the state of infrastructure in the Chilean territories.
8. FAT ("Fondo de Asitencia Técnica"): This program has the objective to speed technological progress by financing technology-consulting expenses for small companies.
9. PROFO ("Proyecto Asociativo de Fomento"): CORFO aids to the creation of technology clusters by financing collaborative efforts of several companies.
10. Invest@ (Programa de Promoción de Inversiones de Alta Tecnología): In this high technology initiative, national and international sources of capital are made available to Chilean entrepreneurs in the respective fields.

Appendix E – BOVESPA Admission Rules

NOVO MERCADO[126]

The NOVO MERCADO is a listing segment designed for the trading of shares issued by companies that voluntarily undertake to abide by corporate governance practices and disclosure requirements in additional to those already requested by the Brazilian legislation.

The inclusion of a company in the NOVO MERCADO implies the adhesion to a series of corporate rules, known generically as “good practices of corporate governance” which are more rigid than those required by the current legislation in Brazil. These rules, consolidated in the Listing Regulation, increase shareholder’s rights and enhance the quality of information commonly provided by companies. Additionally, the creation of a Market Arbitration Chamber for conflicts resolution between investors and companies offers a safer, faster and specialized alternative to investors.

The main innovation of the NOVO MERCADO, when compared to the current legislation, is that non-voting shares may not be issued. However, this is not the only difference between what is required of listed companies at present. In summary, the publicly listed company that participates in the NOVO MERCADO has the following additional obligations:

- → The holding of public share offerings through mechanisms which favor capital dispersion and broader retail access;
- → Maintenance of a minimum free float equivalent to 25% of the capital;
- → The same conditions provided to majority shareholders in the transfer of the controlling stake will have to be extended to all shareholders (“Tag Along” rights);
- → Establishment of a single one year mandate for the entire Board of Directors;
- → The annual balance sheet to be made available in accordance with US GAAP or IAS;
- → Introduction of improvement in the quarterly information report, among which is the requirement of consolidated financial statements and special audit revision;
- → Obligation to hold a tender offer by the economic value criteria should a decision be taken to delist from the NOVO MERCADO;
- → Adherence to disclosure rules on the negotiation of assets issued by the company in the name of the controlling shareholders or the company management.

A contract signed between BOVESPA and the company with the participation of the controllers and the management ensures the company’s acceptance to the NOVO MERCADO, enabling its entrance in this segment.

[126] BOVESPA, 2001

Special Corporate Governance Levels[127]

BOVESPA lays down a series of standards for the conduct of companies, managers and controlling shareholders considered as important for valuation of shares and other assets issued by the company. The adherence to these practices distinguishes a company as either Level 1 or Level 2 depending on the degree of commitment assumed by the company.

Level 1 Companies largely undertake to improve methods of disclosure to the market and to disperse their shares among the largest number of shareholders possible. Thus, the principal practices required of a Level 1 Company are:

→ maintenance of a free-float of at least 25% of the capital;
→ holding of public offerings for placing shares through mechanisms that favor capital dispersion to a broader spectrum of shareholders;
→ improved disclosure of quarterly information including the obligation of reporting consolidated figures and special audit revision;
→ adherence to the disclosure rules for transactions involving assets issued by the company on the part of the controlling shareholders or company management;
→ disclosure of shareholder agreements and stock option programs;
→ provision of an annual calendar of corporate events.

To be classified as a Level 2 Company, in addition to the obligations of Level 1, the company and its controlling shareholders must adopt and observe a much broader range of corporate governance practices and minority shareholder rights. In summary, the criteria for listing as a Level 2 Company are:

→ a single one-year mandate for the entire Board of Directors;
→ the annual balance sheet to be made available in accordance with US GAAP or IAS;
→ granting to all holders of common shares the same conditions obtained by the controlling shareholders on the transfer of the control of the company and 70% of this conditions for preferred shareholders;
→ voting rights granted to preferred shares in certain circumstances such as transformation, incorporation, spin-off and merger of the company and approval of contracts between the company and other companies of the same group;
→ obligation to hold a tender offer by the economic value criteria should the capital be closed or registration as a Level 2 Company be cancelled;
→ adherence to the Market Arbitration Chamber as vehicle to resolve corporate disputes.

All these rules are consolidated in the Listing Regulations, the adherence to which is voluntary. The commitment entered into by the company, its controlling shareholders and its management are signed via a contract to which these entities and BOVESPA are parties.

[127] BOVESPA, 2001

Appendix F – Venture Capital and Private Equity Funds

According to our criteria for the new type of venture capitalists only funds with a local presence in the respective countries are listed.

Argentina:

Venture Capital
Antarctic Ventures
CIMA Investments
Dolphin
Innova
InverPYMES
IRSA
Next International
Patagonia Fund
Pegasus
Penguin Holdings
PCP
Pymes Argentina
Sli Ventures
Small Enterprise Growth Fund
Softbank

Private Equity
Advent International
Banco Rio Private Equity
Bank of America
Grupo BISA
BGN Private Equity
Boston Investment Group
CEI Citicorp Holding
CSFB
DLJ / Chase Capital Partners
Compass Capital Management
The Exxel Group
Galicia Advent
GE Capital
Hicks, Muse, Tate & Furst
Intel Capital
JP Morgan
Ludwig Investments
Merchant Bankers
Newbridge Latin America
Southern Cross
TCW
The Tower Fund
UBS Capital
Warburg Pincus
Westsphere

Brazil:

Venture Capital
BLM Venture Capital
Brasil Venture Fund
CRP
Dynamo
Eccelera

E-nicial
e-Platform Venture Partners
IP.com
KBS
International Real Returns
ITC Ventures
LatinValley
Latintech Capital
Mercatto
NetValor, Banco Modal
Softbank
Stratus Investimentos

Private Equity
Advent International
AIG Capital Investimentos do Brasil
ABN AMRO
BancBoston Capital
Bank of America Equity Partners
Baring Private Equity Partners
Brasil Private Equity / CSFB
DLJ / Chase Capital Partners
CVC Opportunity
Darby Overseas Investments
Electra Fleming
FIR Capital Partners
GE Capital do Brasil
Goldman Sachs Principal Investing
GP Investimentos
Icatu Equity Partners
Intel Capital
JP Morgan
Matrix
Merrill Lynch
Newbridge Latin America
Pactual Electra Capital Partners
Patrimônio
PIP
Rio Bravo Investimentos
Santander Private Equity
The Southern Cross Group
Sul America Capital Partners
TCW
TMG Capital Partners
UBS Capital
Unibanco
Votorantim
Warburg Pincus
Westsphere

Chile:

Venture Capital excl. FIDE funds
Ventures Latinas
ILatinHoldings
ITC Ventures
Latinvalley (MIFactory)
Ventana Global

Private Equity
Compass Capital Management
CVC Latin America
Moneda Asset Management