



# BEST PRACTICES IN CREATING A VENTURE CAPITAL ECOSYSTEM

By

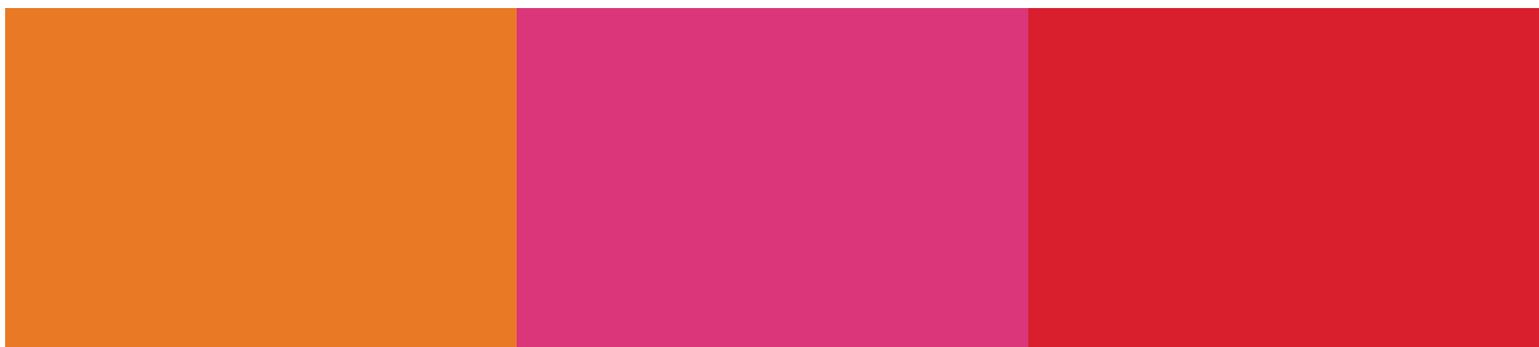
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# PREFACE THE IMPORTANCE OF A VENTURE CAPITAL ECOSYSTEM

A person wearing a white long-sleeved shirt is holding a large, realistic-looking globe of the Earth. The globe is tilted, showing the continents of North and South America. The person's hands are visible at the bottom of the frame, supporting the globe. The background is a plain, light color.

Venture capital as a distinct industry and asset class traces its beginnings only to the middle of the 20th century. This does not mean that risky ventures were not being funded by private investors before then—private investors backed Alexander Graham Bell's commercialization of the telephone and the 13th century Venetians' trading voyages to Asia. But venture capital is a relatively new phenomenon, as is the study of its impact upon the rest of the economy.

One element in particular has drawn great attention of late: The ability of venture capital investment to spur innovation and create jobs. The impact of venture capital upon innovation was examined by Sam Kortum and Josh Lerner.<sup>1</sup> Examining evidence across 20 industries, they determined that venture capital seemed to be three to four times more powerful than corporate research and development in terms of fostering innovation. For many years in the U.S., venture capital investment made up only 3% of corporate R&D spending, yet was responsible for between 10% and 20% of privately funded innovations.

More than ever, with populations growing, markets uncertain, and large employers re-trenching, entrepreneurship offers critical paths to job growth and innovation. An innovation economy, in turn, generates its own energy for a country by offering opportunities for its youth and for individuals who may have been educated abroad yet are eager to return home if

they see opportunities. Both India and China have experienced a substantial return of foreign educated nationals recently, and one study found that a majority of these individuals planned to start businesses within five years.<sup>2</sup> Along with wanting to be close to family, these returnees were also influenced by the prospect of economic opportunities in their home countries. Venture-funded entrepreneurship creates these opportunities and in doing so, helps to create a sustainable culture of innovation and risk-taking.

In the wake of the global economic collapse, governments seeking to create an innovative economy are increasingly looking to venture capital. They are practically forced to do so, as global banks seem even less inclined to make risky investments and stock markets are less reliable as sources of corporate funding for innovation.

The global venture capital industry has struggled since the 2001 NASDAQ crash. Emerging markets have offered attractive returns to later stage investments, but for earlier stage investments, many obstacles still exist, ranging from employment legislation to regulations on stock market listings. Governments in Latin America and the Caribbean (LAC) have definitely made progress in opening their markets to venture capital investment, as seen in the record-breaking amounts raised and invested in 2011.<sup>3</sup> But to establish a vibrant and grounded indigenous industry, rather than merely riding the roller coaster of international interest, governments have an important role to play.

The impact of government intervention in creating a venture capital ecosystem is often overlooked. The U.S. military was deeply involved in the development of California's Silicon Valley, and the government's investment in DARPA-Net, the precursor to the Internet, paved the way for such successes as Google and Facebook, among many others. Government programs have also been important in supporting the venture capital industries in Israel, Brazil, and Australia; they essentially gave rise to the entire private equity<sup>1</sup> industry in the United Kingdom; and changing government regulations to allow foreign investment helped create the private equity booms in China and India.

The challenge for governments is that public intervention requires a careful balance.<sup>4</sup> While the big hubs of venture activity around the world owe much to government assistance, there are also myriad examples of government efforts gone awry. For instance, much of the explosive economic growth seen in Dubai stemmed from government support, but its building boom, funded by the government and government-linked corporations, is thought to have over extended the country's resources. In late 2009, the emirate was forced to request \$10 billion from its fellow city-state, Abu Dhabi, to avoid default by a state-owned property developer that might have created.<sup>5</sup>

Indeed, as our research has shown, many governments on all levels (local, state/provincial, regional, and national) have wasted billions of dollars in misguided efforts to create a healthy venture capital environment. Such misadventures, however, are no excuse for governments to throw up their hands in despair. While the project is not easy, with careful thought and attention to the guidelines described here, the goal can be accomplished.



ONE ELEMENT IN PARTICULAR HAS DRAWN GREAT ATTENTION OF LATE: THE ABILITY OF VENTURE CAPITAL INVESTMENT TO SPUR INNOVATION AND CREATE JOBS.

1. By "private equity," we mean all types of privately held securities, running from early stage investments through growth equity to leveraged buyouts.



# INTRODUCTION HOW TO USE THESE GUIDELINES



This report is targeted to three main audiences:



## POLICY MAKERS.

Policy makers face a difficult task. Often, someone in the Treasury or Economic Policy department simply receives the assignment to create a program to sponsor venture capital or entrepreneurship. Part of the urgency behind the assignment may stem from an upcoming election or criticism from the press. Because the support for a particular program may wax and wane with the party in power, it can be particularly difficult to develop a policy fostering a long-term investment strategy such as venture capital, especially with little notice. We hope that having a handbook readily available will accelerate the policy maker's understanding of the topic and provide useful guidelines for his or her recommendations.

## REGULATORY AGENCIES.

The proper set of incentives is critical for creating a hospitable climate for venture capital. Yet regulators are often beset by a number of conflicting desires: for instance, stock exchange regulators might be torn between wanting to ensure that only stable, mature companies go public (to reduce the risk to shareholders) and providing an exit avenue for young high-growth companies that pose greater risks. Business licensing groups may want to prevent individuals who have previously gone out of business from losing money again—yet how else is an entrepreneur to learn how to run a business? Employee protection groups may want to preserve jobs, but as young companies grow and change, they necessarily must change their workforce to respond to the business needs. These guidelines are intended to increase the regulators' understanding of the industry and its patterns, along with the role that their institutions (stock exchange, taxing authority, business licensing, or employee protection to name a few) play in fostering venture capital activity.

## INVESTORS.

Investors in funds and fund managers: As we describe, policies that benefit specific groups may not be good for the industry overall. By understanding the various forces and incentives at play, we hope that investors and fund managers will be better able to grasp the trade-offs that help to create a vibrant venture capital ecosystem and result in gains to all parties.



# STRUCTURE OF THE REPORT



We begin by discussing the background of this project, with particular attention to the role of the Multilateral Investment Fund (MIF), which has been a long-time investor in the Latin American and Caribbean (LAC) region and has played an important role in developing the VC ecosystem there, as well as encouraging others who have played important roles.

We next discuss the initial question of why an emerging market should care about a healthy VC ecosystem. One might point out that emerging markets have many other concerns, including education, health, income distribution, the environment, and civil society. Our argument is that not only does venture capital fuel growth directly, but many of the preconditions for a healthy VC ecosystem contribute to and encourage a growing economy, which in turn helps a country develop through what economists call “externalities”—benefits that accrue to society as a whole.<sup>6</sup>

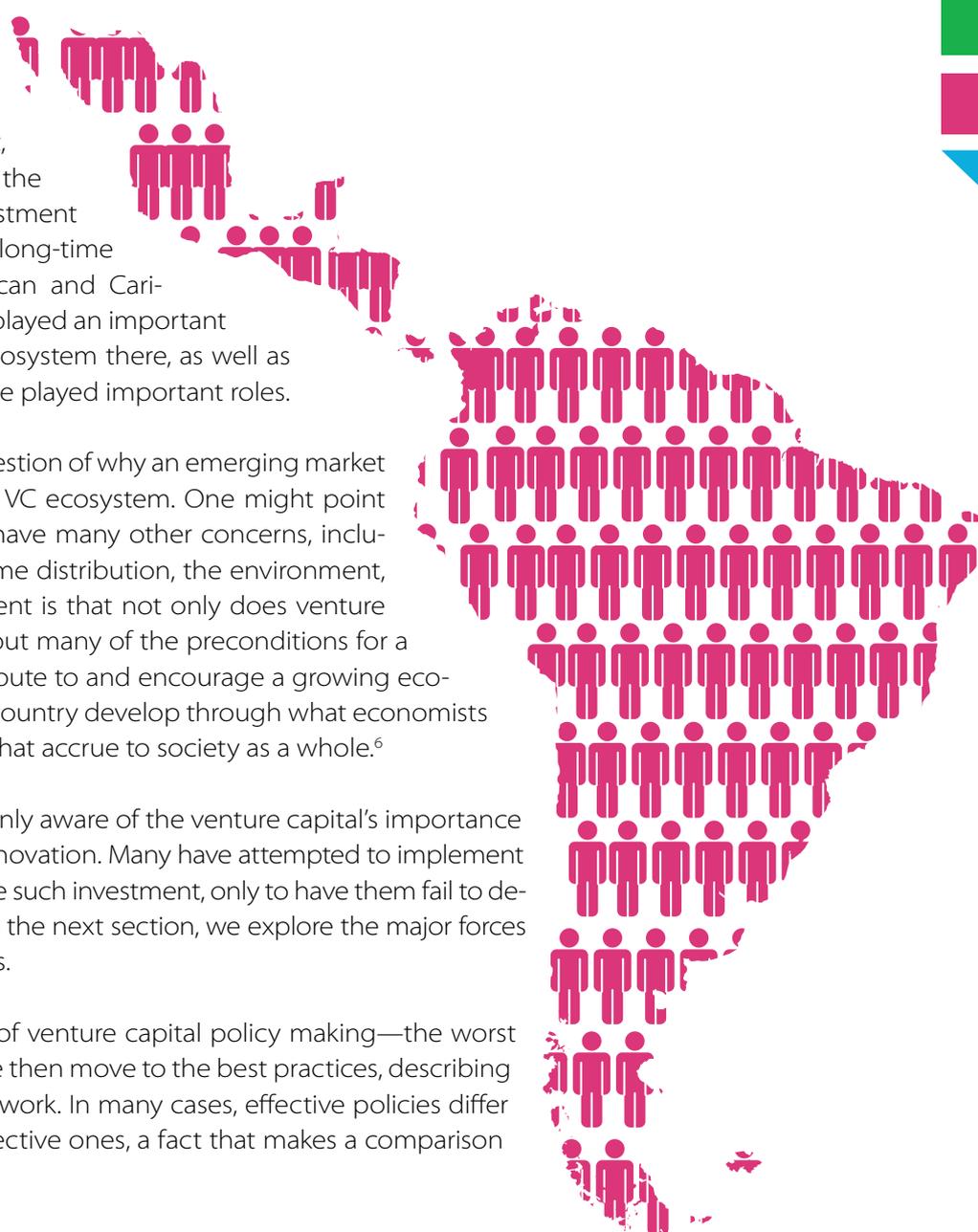
Governments have been keenly aware of the venture capital’s importance in stimulating growth and innovation. Many have attempted to implement policies that would encourage such investment, only to have them fail to deliver the anticipated results. In the next section, we explore the major forces behind such disappointments.

Having explored the pitfalls of venture capital policy making—the worst practices, one might say—we then move to the best practices, describing what they are and why they work. In many cases, effective policies differ only in the details from ineffective ones, a fact that makes a comparison particularly important.

The next section considers three efforts within LAC itself. Each of the three—the INOVAR program developed by Brazil’s FINEP; Mexico’s Fondo de Fondos (fund of funds); and Chile’s Start-up Chile program—addresses a different aspect of the VC ecosystem. Together, they make a fascinating example of the various ways in which policy can support innovation and entrepreneurship.

Finally, we review the material covered thus far and make some recommendations. While every country has its own unique challenges, certain common themes have emerged from the research done to date. Moreover, humans respond to incentives in similar ways. Thus, while each country will adopt its own unique set of policies, we would expect—and even hope—that at their core, they will have much in common.

In Appendix 3, we provide reports from two fund managers that detail the lessons they have learned during their activity in Brazil and Uruguay. In both situations, we observe the evolution of fund management in the midst of a rapidly evolving ecosystem and can see the development of a unique, indigenous, and yet very recognizable, venture capital industry.





# EXECUTIVE SUMMARY

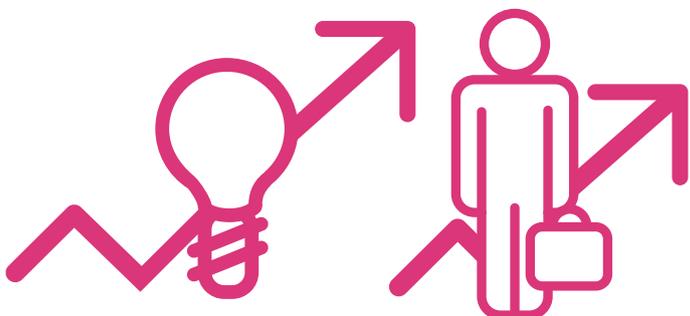
Venture capital investment has been found to be remarkably effective at stimulating innovation and job growth.<sup>7</sup> Moreover, many of the conditions required for a thriving venture capital market—financial and legal transparency, a judiciary that enforces contracts, a liquid stock market—are desirable in emerging markets. Growth equity investment and leveraged buyouts often derive from a country's existing industrial base, as family owned businesses seek financing and advice for their own growth and state-owned conglomerates are rationalized into nimbler and more focused enterprises.

Venture capital, however, involves long term investments in risky, young companies, often with unproven management teams addressing new technologies in uncertain markets. Yet the innovation that occurs in these small companies is an important force in moving a country into the knowledge economy, which can balance a prior dependence on resources or extraction. In addition, it can attract talented nationals who were educated elsewhere and are eager to return to either start or invest in exciting companies in their home country.

Government policy plays an important part in creating an ecosystem in which venture capital and innovation can thrive. The areas that are synonymous with innovation and venture capital around the world, in Silicon Valley, Israel, or Singapore, all were fostered by government programs. Yet government programs have also sunk billions of dollars into misguided efforts to inspire venture capital and innovation. In this paper, we examine the hallmarks of good and bad programs and then consider three programs adopted by governments in Latin America and the Caribbean.

The principle recommendations are straightforward. There is no “silver bullet” that will create a vibrant venture capital ecosystem in every country. A critical part of every country's approach must be its own careful consideration of its needs, resources, and current structure. Merely copying a neighbor's infrastructure, as seen in the Middle East as countries tried to emulate Dubai's success as a transport and financial hub, rarely succeeds. Instead, the process is much more effective if a country tailors its strategy to its own strengths and opportunities. It is also, of course, much more uncertain to embark on a bold course rather than to point at a neighbor's approach and say, “it worked for them; it will certainly work for us.”

VENTURE CAPITAL INVESTMENT  
HAS BEEN FOUND TO BE  
REMARKABLY EFFECTIVE AT  
STIMULATING INNOVATION  
AND JOB GROWTH



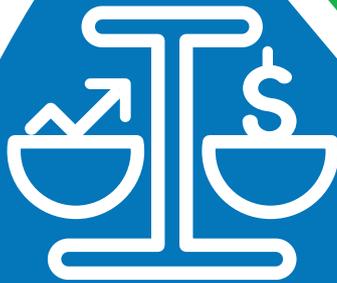
The three chief recommendations for creating a vibrant venture capital system are listed below:

2

## LISTEN TO THE MARKET.

Policy too often founders on the idea that “if you build it, they will come.” History is rife with examples of policies that provided lots of money for investment in areas with few viable opportunities. Such programs usually result in one of two outcomes: enterprising individuals figure out how to gain the rewards yet create little meaningful change or a substantial amount of infrastructure is built (buildings in particular) and few businesses choose to occupy them. Market input can be gathered in several different ways. In some cases, policy makers interview market participants directly to determine their needs. In others, market needs can be discerned by observing international norms and determining their difference from domestic practices. Finally, a powerful method for obtaining market input is to offer matching funds to

1



Set the table. It is critical that the basic regulations and incentives should be in place. Tax policy that encourages long-term capital investment spurs entrepreneurs to take the risk of starting their own companies. Regulations that allow the limited partnerships streamline the establishment of the most common venture capital investment structure. Labor mobility, both geographically and in terms of hiring or leaving, is also important to allow both employers and employees to adjust to changing situations. Bankruptcies must be allowed because otherwise, an entrepreneur can never act upon the hard-won learning in past failures. Financial vehicles such as stock with different powers provide venture capitalists with an important tool for guiding businesses and obtaining rewards for their risks.

## SET THE TABLE.

14



groups that will invest in areas of interest. Some programs may also cap the returns to the government-provided funds, thereby increasing the returns to the private investors. Another approach has been to provide government-funded loans, loan guarantees, or loss reimbursements. These tend to be less effective, because lenders have less direct power to change a company's performance and loss reimbursements simply reduce the pain of bad decisions rather than encouraging good ones.



In a sense, this incorporates aspects of the two prior points. Revising a program allows it to adjust to changing market realities. A program aimed at a particular sector or stage of company growth may no longer be needed, while other groups may seek support. As a market evolves so will the role of government. The provision of market information is crucial at the start of a country's attempts to create a venture capital industry; as the market matures, this role may be adopted by private groups. For the government to insist upon this role for itself, except in terms of gathering macro-economic data, may be counterproductive. Policies may also need to decide how to balance supporting a domestic industry with encouraging international players. The international groups bring large amounts of money, awareness of best practices, and wide networks. Domestic groups know the market. By encouraging the two to work together, the industry learns and grows and the domestic innovation environment is strengthened.

**GET  
THE DETAILS  
RIGHT.**

**3**

In the case of LAC, there are two well-respected roadmaps that governments can use to guide their efforts in creating a venture capital ecosystem. First, the World Bank's Doing Business Rankings (<http://www.doingbusiness.org/rankings>) provide an objective rating system. These rankings are more powerful when viewed relatively, rather than absolutely: instead of trying to increase the ranking by 2 points, it is more illustrative to note the difference between one's country and the highest ranking nation in LAC and then overall. By prioritizing its areas of greatest weakness, a government can focus scarce resources on the improving the greatest weakness in its business environment. Secondly, the Latin American Venture Capital Alliance (LAVCA) in partnership with The Economist, the MIF and the Development Bank of Latin America (CAF), publishes an annual scorecard that ranks the 12 major economies on their friendliness toward venture capital. Addressing the shortfalls between one's own country and the highest rated nation can focus a government's efforts. (For samples of both scorecards, please see Appendix 1 and Appendix 2).

## CONCLUSION

Many governments at many levels have seen encouragement of a venture capital ecosystem as a chance to invest directly in interesting technologies. Nowhere in the above list or in the report that follows is this particular approach encouraged. Policy makers have many talents but direct investment in and supervision of high-risk young companies is rarely among them. We recount a few of many situations in which such strategies have not succeeded –and cost the taxpayers substantial amounts of money. Yet policy makers and governments have critical roles to play. They must assess the current situation and its needs; enact the proper regulations and structures; develop the policies that reward the right behavior; and continue to refine and revise the programs to best meet the market's needs.

The venture capital industries that have flourished around the globe had important help from governments. The task is not easy. But with care and attention, it can be done.



# BACKGROUND OF THE GUIDELINES

FOMIN



The Multilateral Investment Fund (MIF) is part of the Inter-American Development Bank (IDB) Private Sector Group. The MIF plays a distinct role within the IDB Group, pursuing innovative ways to build economic opportunity and decrease poverty. It has successfully tested, experimented and searched for innovative solutions and approaches, and attempts to be an effective agent of change by achieving large-scale, sustainable change in the thinking or behavior of individuals, policy-makers, organizations or businesses.

Founded in 1993, the MIF first became involved in venture capital investing in 1996. The timing was opportune: during the previous decade, the region had undergone a number of changes as governments became more democratic and started to open their economies. In the late 1980s, some of the state-owned companies were privatized, creating great opportunities for leveraged buyout practitioners, a few of which were domestic firms. From its inception, the group funded private equity efforts, most often those focused on early stage venture capital as a way to create self-sustaining economic vitality and to benefit those at the “base of the pyramid.” In addition, the MIF’s Early Stage Financing group has worked to create a VC ecosystem and provide for knowledge transfer.

By 2011, the MIF realized that its long history in the region gave it an unparalleled vantage point from which to observe the changes that have occurred and share the lessons that it has learned. These were compiled in Maria Susana Garcia-Robles’ article, “Fifteen Years of Lessons Learned,” published in the Latin American Law Review and in Venture Equity Latin America VE-LA.<sup>8</sup>

Recently, the MIF’s Early Stage Equity group decided that it needed to provide a platform from which the various policy-makers across LAC could learn from each other. As a first step in this program, the group sponsored a daylong program in May 2012 in which 36 policy makers and regulators from 13 countries met to discuss issues around creating a VC ecosystem. Led by Professor Josh Lerner from Harvard Business School, the forum included discussions on the case of Start-Up Chile followed by a white paper on Brazil’s INOVAR program, then heard a lecture by Dr. Lerner on government policies for fostering entrepreneurship and venture capital, and concluded with a vigorous discussion of four issues confronting policy makers.

These guidelines are the next step in the effort to share lessons across the region. We hope that by providing the theoretical foundation along with global experiences and complementing that with the experiences of regional practitioners, the parties through LAC who are involved and invested in creating a thriving VC ecosystem will be boosted up the learning curve and avoid some of the mistakes that have dogged prior efforts. In so doing, we hope to accelerate not just the region’s private equity industry, but its overall economic development as it uses more efficiently and transparently the abundant resources—natural and human—with which it has been blessed.

**36** POLICY MAKERS  
AND REGULATORS

**13** COUNTRIES



# 1.

## WHY IS A HEALTHY VC ECOSYSTEM IMPORTANT IN AN EMERGING MARKET?

Private equity in Latin America and the Caribbean (LAC) is a relatively recent phenomenon. Data on fundraising for the region only goes to 1993, when US\$123 million was raised. Fundraising soared to US\$3.7 billion in 1998, only to crash to a low of US\$407 million in 2002 in the wake of the collapse of the Argentine economy and the fall of the NASDAQ. After a few years of fundraising below US\$1 billion, the industry recovered to reach 2011's peak of US\$10.13 billion. Investment followed similar patterns, as shown in Figure 1 below.

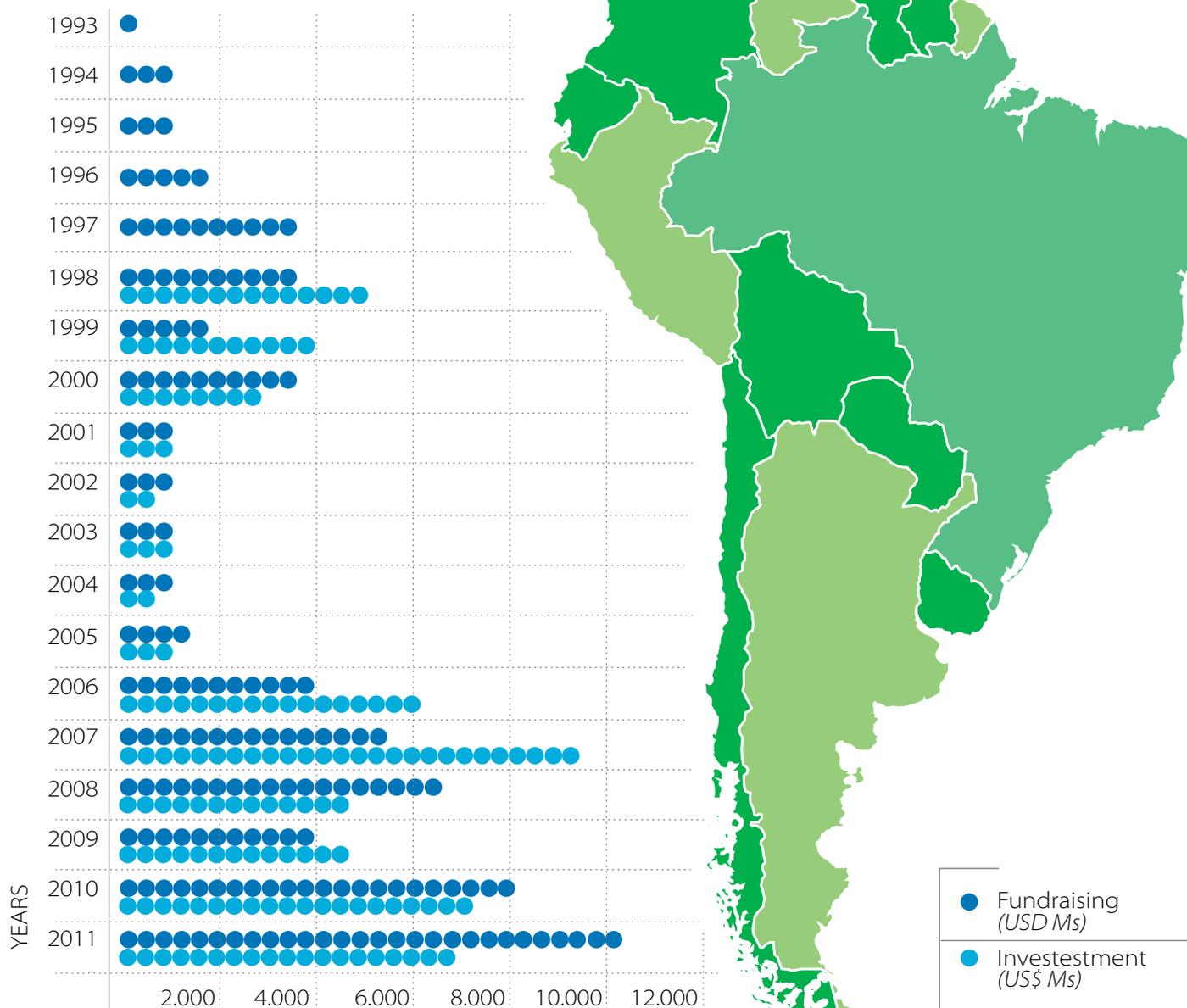
*the industry recovered  
to reach 2011's peak of*

**US\$10.13 BILLION**

**FIGURE 1**

Fundraising and Investment in LAC, 1993-2011

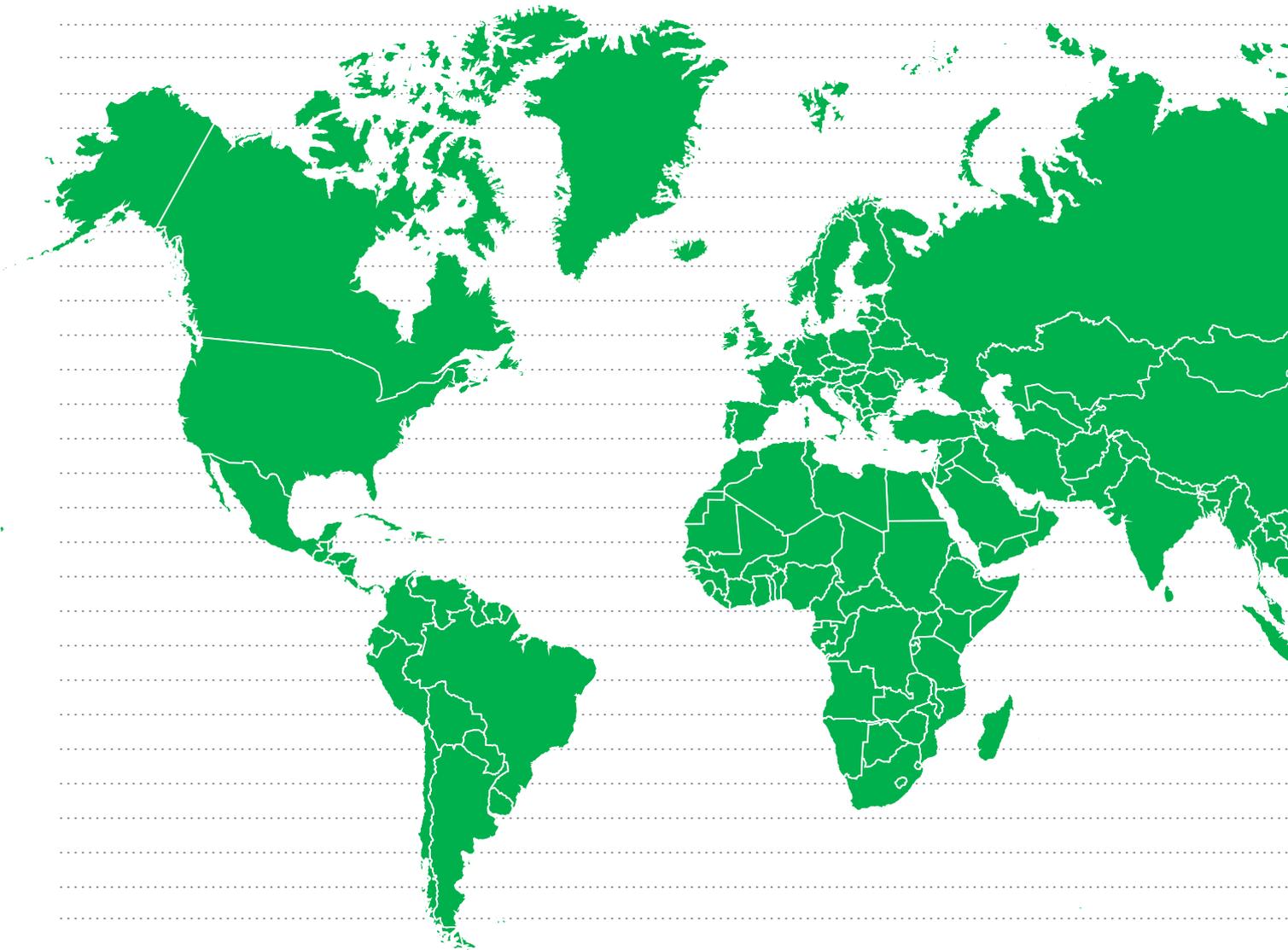
Data from LAVCA2011 Industry Data, pp. 2 and 4. Data prior to 2008 is based on VE-LA reports. Investment data prior to 1998 is missing.



Even with such significant growth, private equity accounts for a percentage of GDP for any of the regional economies that is roughly half the 1.0% to 2.0% observed in the United States. As shown in Figure 2, even in Brazil, the leading destination among LAC countries, 2010's private equity makes up only 0.27% of GDP. The percentage for venture capital alone is even smaller: the total for the U.S. in 2010 is slightly under 0.20% and that for Argentina, the highest ranking LAC country, roughly 0.01% while Brazil is only slightly more than 0%.

**FIGURE 2**

Venture capital  
investing as %  
of GDP, 2010



0,00

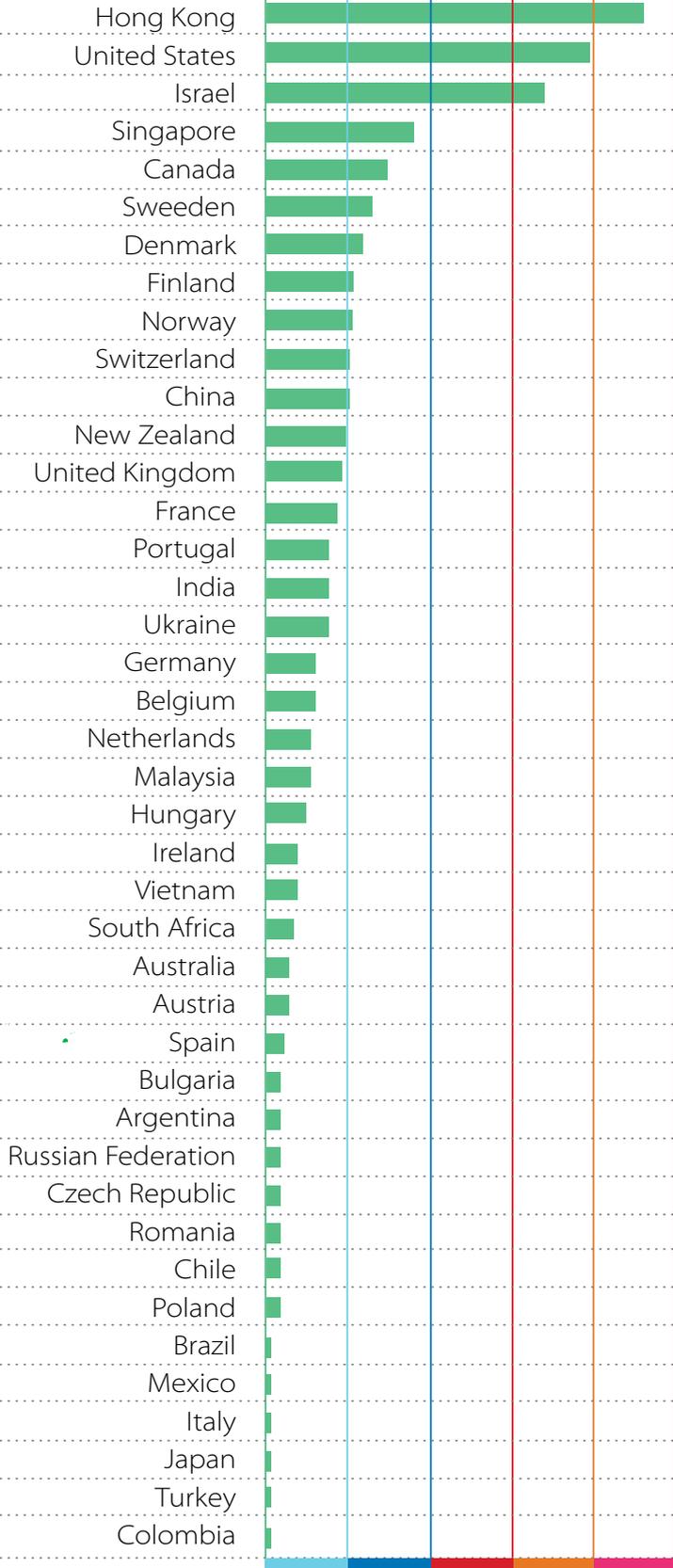
0,05

0,10

0,15

0,20

0,25



With venture capital such a small portion of the GDP of LAC countries, one might argue that buyouts are more suited for the region and venture capital should be considered unsuited for emerging markets. But these data can be interpreted another way: namely, that there is substantial room for venture capital to expand in these markets and that with the proper incentives, guidelines, and regulatory framework, it will do so.

Even though venture capital as an asset class is small and relatively young—the recognizable first fund was raised in 1946 in the U.S.—it plays several important roles that governments should wish to encourage. In particular:

**1 Young innovative firms and those that are restructuring pose a tremendous number of challenges.** Investors must choose the right investment. They must manage that company, possibly changing management teams or advising on product development or marketing strategies. Over time, young companies often need more money, so the investors must be prepared to infuse additional funds, possibly attracting new investors. They need contacts to help the companies find customers or navigate complex situations. Finally, the investors must exit the company. This may mean finding a corporate parent and negotiating an agreement or assisting the operation with listing on a stock market. A restructuring firm also needs help in revising its operations and possibly changing the markets that it addresses or the products it sells. These skills are vastly different from those of a banker, who evaluates credit risk, or an insurer, who considers other types of risk. Even venture capitalists and buyout practitioners have discovered that their skills are not interchangeable.<sup>9</sup>

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**2 These ventures have been found to create job creation and substantial wealth.** Studies have shown that the smallest operations generally create the largest number of jobs. The U.S.-based National Venture Capital Association in its most recent study found evidence that companies that had received venture capital investment (as noted earlier, less than 0.2% of U.S. GDP) generated revenue equal to 21% of U.S. GDP in 2010. Of the 107.3 million U.S. private sector jobs in 2010, 11% came from companies backed by venture capital.<sup>10</sup> For buyouts, the data is less straightforward: an assessment done by Josh Lerner and colleagues found that companies that underwent buyouts initially lost jobs but then added them, ending at roughly the same employment level.<sup>11</sup> Evaluating returns from private equity is difficult because much depends on timing. For instance, the pooled average annual internal rate of return (IRR) to U.S. venture capital funds for the 10 years ending December 1983 was 24.8%; that for the following decade was 8.1%. For the ten years to December 2000, the average pooled IRR was a staggering 25.7%, only to be followed by a miserable -0.8% average over the next decade. Yet if one chose the ten years ended June 2012, performance perked up to a more respectable 3.5%.<sup>12</sup> This performance differs substantially if one examines the top tier firms. Unlike mutual funds or bond funds, returns to venture capital and buyout funds depend profoundly on the individual manager. If an investor can get into a top quartile fund, returns are likely to be between twice and four times those of the median. If one cannot, returns are better in the public markets.<sup>13</sup> When the investors in private equity funds are pension funds and various endowments, such returns boost support to retirees, educational institutions, charities, and other important organizations.

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**3 Private equity owned companies are better managed.** In a study of governance styles associated with different types of ownership, Nicholas Bloom and coauthors determined that private equity-owned companies across the U.S, Asia, and Europe were on average the best managed of the group of 4,000 studied.<sup>14</sup> Compared to the others that were government-, family-, or privately owned, the private equity-owned companies did a better job of managing people, operations, and performance. In addition, this outperformance persisted even after the private equity firm had exited. Hence, private equity management methods tend to be better overall and increased presence of this type of governance in an economy will tend to increase the general level of management performance.

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**4** Being involved in an entrepreneurial company creates more entrepreneurship. There is a strong demonstration effect associated with entrepreneurship. A study by the Community Development Venture Capital Alliance showed that even when a venture-backed company closed down or was sold and moved out of the region with the resulting loss of jobs, individuals who had been employed in that company were more likely than others to start their own companies.<sup>15</sup> This phenomenon is also true on a larger level. Companies such as Fairchild Semiconductor, Google, and Intel, are known for their spin-off companies as engineers left to start their own operations.

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**5** Venture-backed companies produce “quality” innovations. Judging the value of an innovation is difficult—22 years ago, the Internet was seen as an odd way for scientists to share information. To assess the value of venture-backed innovations as opposed to those funded by other methods, Josh Lerner looked at the question in several ways. First, he and Sam Kortum in the article referenced earlier determined that while venture capital made up roughly 3% of corporate R&D between 1983 and 1992, it produced roughly 10% of the commercial innovations. The quality of these patents can be assessed by reviewing the number of times subsequent innovations cite them, and amount of litigation taken to protect them. Kortum and Lerner further find that the patents of venture-backed firms are more frequently cited by other patents and are more aggressively litigated—thus it can be concluded that they are high quality. These findings reinforce the notion that venture-supported firms are simply more innovative than their non-venture-supported counterparts.

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**6** Finally, emerging economies are doing more innovation, which offers more opportunity for venture capitalists to invest.<sup>16</sup> In part, this reflects a basic change in the nature of innovation. Where advances in high technology once required access to supercomputers or clean rooms, it can now occur using off-the-shelf tools like iPhone app development packages. Crowd-sourcing allows a developer access to vast amounts of widely dispersed talent on an as-needed basis. But the trend also reflects the growth of emerging economies and the increase in education levels—China has 5 million college graduates annually; India 3 million—, which means that more smart people have the training to think innovatively. Innovation, it is important to remember, need not involve creating a completely new product but often involves incremental improvement, like Dell’s distribution system, Google’s search method, or Facebook’s more intuitive system. The local venture capital firms are more likely to know of these innovations and appreciate their importance to the local market. Investing in these opportunities creates the demonstration companies that inspire an entire economy to start innovating.

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# A. EXTERNALITIES

Many of the benefits listed above spill over to society as a whole. While venture capitalists are undoubtedly pleased that the employees of their company develop an entrepreneurial spirit, they do not plan for this result. Like the increased solvency of pension funds that invest in top-tier venture capital operations, these benefits occur without the active intention of the venture capitalists yet benefit much of society. Such “externalities” are part of the reason that governments have a legitimate role to play in encouraging venture capital activity.

Other externalities stem from challenges faced and resolved by early investors that benefit the later entrants in the industry. That is, it is easier to do the 100th deal than to do the first—which therefore means that an early entrant is at a comparative disadvantage, because the benefits of the work they do accrues to others. Many investors who pioneered private equity in emerging markets recount having to build a set of expectations among entrepreneurs along with associated ancillary expertise, such as lawyers, accountants, investment bankers, and human resource specialists. Doing a later deal becomes much easier because the entrepreneurs know what to expect and the investors need not explain the mechanics. Moreover, intermediaries will have developed necessary expertise to make the transaction occur smoothly. In addition, a network of firms begins to develop with the associated sharing of information and deal flow. Studies have shown that specialist investors outperform generalists.<sup>17</sup> As an ecosystem evolves and deal flow improves, firms tend to follow this pattern. Firms develop networks through which they can refer entrepreneurs to one another and/or share deals. Finally, as the institutional investors gain comfort with the asset class, two dynamics occur: first, the initial investors become willing to invest more and in more nascent funds; and institutions that had earlier stayed on the sidelines become willing to invest. Over time, entrepreneurs who have succeeded with their venture-funded companies start to participate as investors, either funding very young companies as angels or investing in funds as limited partners.

Economic theory holds that when substantial positive externalities can be generated by private efforts, the government has a natural role to play. Government policies can and should remove obstacles to venture capital investment and create regulations that permit and even encourage it.



## B. TWO BRIEF CASE STUDIES

The first recognizable venture capital effort was American Research and Development (AR&D), managed by Harvard Business School professor Georges Doriot. He was concerned that coming out of World War II, the United States economy would plunge back into the malaise of the Great Depression. At the time, the country had no institutionalized way to fund young, innovation companies. Banks wanted to be sure their loans were repaid, which precluded their interest in supporting companies likely to incur short-term losses. The public markets wanted a history of profits, which was also impossibility. Doriot saw the need for a financial institution that would perform three critical roles:

### CHOOSING

That is, selecting from the host of opportunities those that seemed most likely to succeed. While today the industry in the United States has 60 years of experience (and still makes mistakes), Doriot and his team had to invent methods of evaluating companies with scanty track records and inexperienced management teams.

### GOVERNING

The techniques of active investors were also relatively unknown at the time. Transparency, governance, and other approaches to guiding growing companies were still developing from the laws enacted in response to the Great Depression.

### CERTIFYING

Qualifying for funding and enduring the investors' scrutiny would attest to the fact that the company was of a higher caliber than other operations. Thus, venture-backed companies could be thought to be of higher quality than others, therefore certifying them to others. In particular, this would be useful when the company needed to raise additional money or sought to attract customers.

The idea of venture capital was new and most institutions were reluctant to invest. Instead, AR&D had to raise its funds by selling shares through investment bankers who had underestimated the time it would take the fledgling venture capital firm to generate profits. (This was understandable!) Throughout AR&D's history, Doriot had to stave off urgent requests from the press and his shareholders that the firm should sell its portfolio and return at least some portion of the invested capital. The effort's best-known success was Digital Equipment Corporation (DEC), the early maker of computer mainframes. AR&D's \$70,000 equity investment for 70% of the company, made in 1957, was worth roughly \$450 million nine years later when the company went public. Many of AR&D's investments, though, failed, a fate common to many early stage companies.

Europe's counterpart to AR&D was the U.K's 3i.<sup>18</sup> Like AR&D, it was founded just after the end of World War II to fill a similar funding gap, the scarcity of investment capital for small- and medium-sized enterprises. Jointly owned by the country's largest banks, 3i had to invent many of its investment techniques. Over time, the operation spread across the entire country and trained a large proportion of its private equity professionals, including many of its current competitors. In 1994, 3i went public and shortly joined the FTSE 100. While it has had its share of challenges over the intervening years, it has developed a global footprint as a mid-market investor.

Moreover, in addition to the earlier data regarding venture capital's ability to fund innovation, it also appears to do so in ways that the market recognizes as enduring. As shown in Table 1, U.S. venture-backed companies represent roughly 11% of the total number of U.S. firms. But they are more profitable—although their sales are only 4% of the total, the net income is a disproportionate 6%. They also have 6% of the total employees. And the market thinks highly of their future potential, ascribing to them a market capitalization that is 9% of the total.<sup>19</sup>

**TABLE 1**  
PUBLICLY TRADED VENTURE-BACKED AND NON-VENTURE-BACKED FIRMS AS OF DECEMBER 2010

	Number of Firms	Market	Employees (000s)	Sales	Operating Income Before Depreciation	Net Income	Avg. Profit Margin
VENTURE-BACKED	677	2,298,091	3,397	1,080,500	221,381	111,678	10.2%
NON-VENTURE	5,753	23,634,695	58,101	23,620,702	4,824,474	1,721,312	7.1%

**NOTE:** All dollar figures in millions; all employment figures in thousands.

**SOURCE:** Datastream.

Thus, it appears that a healthy VC ecosystem conveys a number of advantages to a country. VC-backed companies create jobs, encourage innovation, and inspire transparency and good governance. All of these are substantial spill-overs that benefit society as a whole, a clear indication of a legitimate use of government policy.

# 2.

## PITFALLS: WHY EFFORTS TO CREATE AN ECOSYSTEM OFTEN GO AWRY

The foregoing picture seems rosy indeed. An entire virtuous cycle can be created where institutional investors fund venture capitalists who fund entrepreneurs. The entrepreneurs in well-managed operations create quality innovations and future generations of entrepreneurs, even as the original founders put some of their gains into funding further innovative companies.

Certainly, many governments in many countries have created programs to stimulate venture capital. The problem, and the reason for this volume, is that these programs have wasted many billions of tax payer dollars. No government in the current uncertain economy can afford to make such mistakes even in pursuit of a noble goal.

There are two major reasons for the failure of government efforts to stimulate a venture capital ecosystem:

**Incompetence:** The worlds of venture capital and entrepreneurship have specific dynamics and expectations that can trip up the unwary. Furthermore, many well-intentioned efforts are poorly executed. Governments may crowd out the private sector if they invest in already-popular sectors, or interrupt a program before it has time to mature in response to political pressures, such as approaching elections that require the need to show quick results. Good programs started by one administration may be abandoned by another on philosophical grounds.

**“Capture”:** Regulatory capture refers to the ability of people who participate in a project to manipulate it in such a way that the benefits accrue to themselves or people to whom they have connections.



Often, these dynamics work together to create a devil’s brew. For instance, an incompetent group might design a program that fails to produce the desired results and provides an opportunity for well-connected individuals to use the project for their own gain.

# A. EXAMPLES OF SUCH PROBLEMS

A recent example of mis-spent innovation funding can be seen in the U.S. Cleantech Debacle. In the 2005 Energy Act, the Department of Energy (DOE) received authority to guarantee loans made to emerging energy technologies. While this would seem likely to support innovation, mature industries such as nuclear and coal were eligible as well. The agency was authorized to guarantee \$34 billion in loans and to make direct appropriations of \$170 million. These amounts were later increased.

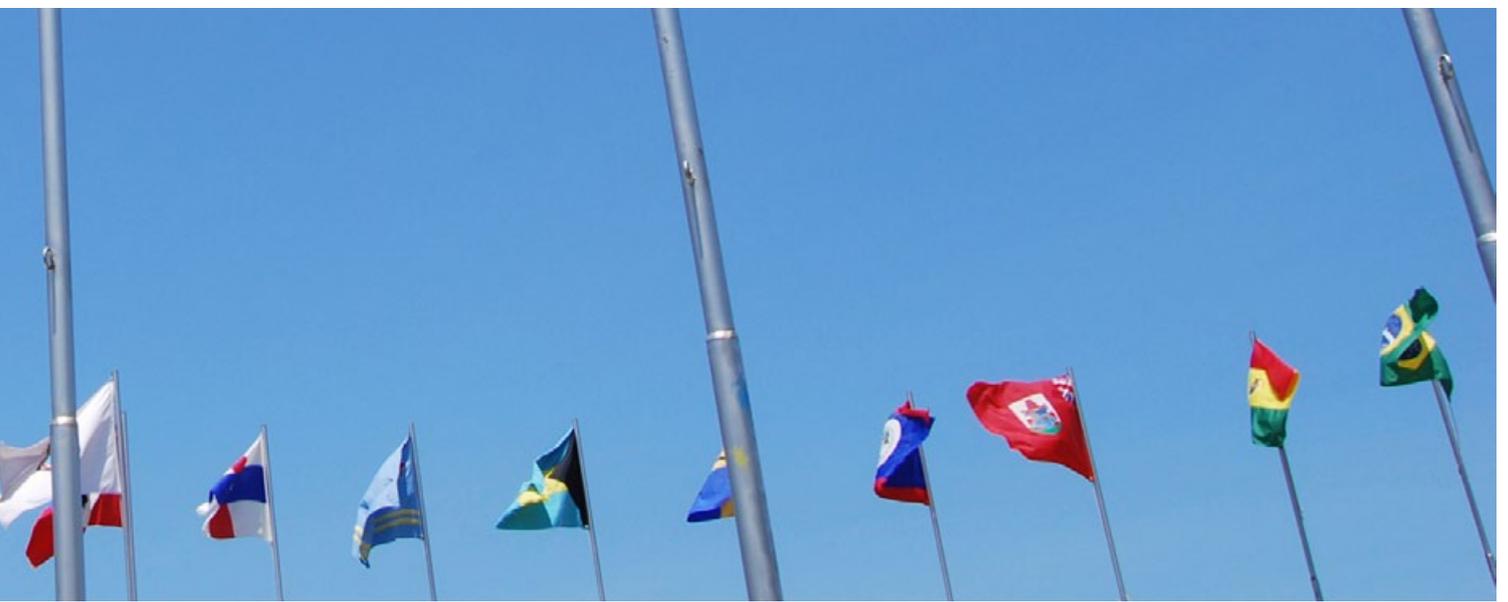
An organization protesting the program noted, “DOE has minimal experience administering a loan guarantee program, and its one test case ended with taxpayers paying a heavy price. In the late 1970s and early 1980s, DOE offered billions in loan guarantees for the development of synthetic fuels. Due in large part to poor administration and market changes, the federal government was forced to pay billions to cover the losses.”<sup>20</sup> The group was wise to worry. People who run the DOE are undoubtedly very good at running a government agency, but their ability to assess high-risk potentially high-growth companies could be questioned. Companies that won these grants, such as Solyndra, a maker of solar cells, and A123 Batteries, a developer of batteries for electric cars, clearly were addressing gaps in the clean tech market. Solyndra received \$529 million in loan guarantees and A123 was awarded \$263 million. But their performance was uninspiring. Solyndra failed, leaving the U.S. taxpayers liable for the guarantees. A123 Batteries went public at \$13.50/share in 2009’s largest IPO but now trades at less than \$1.00. Private investors were also hurt: they had at least \$1 billion in Solyndra and \$70 million in A123.

Many critics argued that the government had no business subsidizing cleantech firms at all. But here the discussion can (and should) become more nuanced. Government funding is supposed to fill gaps where private investors are unwilling to accept the associated risks of actions that would benefit the entire population. Solar energy must fill a critical gap in the energy policy of the United States. Battery technology has been identified as a major choke point in the development of electric cars and more efficient technologies in general. Hence, it can readily be argued that the DOE’s project was exactly what the government should be doing in theory. The motivating idea, then, was good. The execution was faulty.

A large part of the problem had to do with secrecy of the award process, with very little transparency about the criteria used to select firms. As a result, firms responded by hiring lobbyists to seek awards. For example, more than half the cleantech companies in the portfolio of New Enterprise Associates, a large U.S. venture firm, hired lobbyists, as did both Solyndra and A123 Batteries.

Moreover, the large size of the government allocation—several times the amount of venture investment in the space—crowded out private dollars. In this case, though, venture capitalists delayed their funding lest they either back a company which was going to get a huge amount of public funds, or have to contend with a super well-funded competitor. This is a classic situation where a public program targeted an area that was already interesting to private investors and injected money without the oversight that would have accompanied venture capital investment. We later consider a way to address this situation, through the government’s provision of matching funds to professional fund managers who have fiduciary duties to third party private investors. On a smaller scale, another recent debacle is the failure of Red Sox pitching ace Curt Schilling’s video game





and grants them to small, high-tech companies. This sum has been in the vicinity of \$1.5 billion annually. While the grants are supposed to be based on the merit of the applicant without regard to geography, at least one company in each of the 435 congressional districts has received funding in the recent fiscal years. This suggests a substantial degree of pressure from elected representatives to ensure that their constituency receives a share of the federal largesse. Yet many of these companies end up failing and produce few returns either to the private individuals involved (other private investors who may take the SBIR grant as “credentialing”, or evidence of the technology’s potential) or to society as a whole, which invests inefficiently in a company noteworthy more for its location than its technology or likelihood of success.

Some might argue that such a broad geographic distribution is only fair. The difficulty is that entrepreneurship thrives in clusters, where entrepreneurs can share ideas, talented people want to live, and the various support functions, ranging from venture capital firms to intellectual property lawyers to coffee shops, are easily found. An academic study examined the job growth performance of companies that received SBIR grants, comparing those that were located in areas with strong venture capital concentrations with those that were not. The companies in areas of great venture capital availability had greater job growth (close to 50%, compared to 15%) than did those awardees that were not in such regions.<sup>24</sup> This finding demonstrates the impact of the clusters, because the compa-

nies are all SBIR grantees and thus can be assumed to be pursuing important innovations. Thus, while it may be fair to award the grants evenly, the approach is not economically efficient if the goal of the program is to encourage high technology innovation, because some companies are more successful than others.

Even sovereign wealth funds are not immune to the impact of capture. In their study, Shai Bernstein and co-authors found that if politicians were on the investment committee, the fund invested more often in the home country and region and did larger deals.<sup>25</sup> They also found that the politicians appeared to invest at the top of a bubble—the price/earnings ratio of that industry and the country in the year following the deal fell by 3.0%, compared to a 0.8% fall in the industries chosen by funds that did not have politicians on the investment committee.

Again, it can be argued that politicians might be more sensitive to the local scene and choose to support certain industries that are in vogue at the moment, only to have them inevitably fall flat. There might also be valid reasons for investing close to home, whether for local economic development or other reasons. But if the fund’s investment goals were preservation or increase of capital for future generations (often a reason behind the formation of the fund in the first place), investing large amounts in industries about to suffer losses may not be the best way to pursue it.

## B. CAN GOVERNMENT DO ANYTHING RIGHT?

The previous account may leave the reader bewildered and ready to abandon any idea that government policies can foster a venture capital ecosystem. But government policies have played an important role in the creation of the entrepreneurial climates in such countries as China, Israel, Singapore, Taiwan, Chile, and Brazil—not to mention the roles played by the U.S. government in the establishment of Silicon Valley and Boston’s “Route 128,” which stemmed from AR&D’s investment in Digital Equipment, and by the U.K.’s banks in founding 3i.

As a final note, let us briefly consider the role of government in the development of that grand-daddy of all venture ecosystems, Silicon Valley.<sup>26</sup> Widely hailed as a bastion of independent, untrammled risk-taking and capitalism,<sup>27</sup> its trajectory was strongly influenced by first, a history of technology firms that dated to the early 20th century, and secondly, spending by the Department of Defense. To the first point, close contacts with Stanford University, which provided both technology and funding; spin-offs from the original technology firms as early as 1910, which modeled a new way of doing business; and a reliance on local financiers, initially wealthy individual angel investors, created a framework of developing, commercializing, and funding new technologies. To the second point, defense spending supported many of the young companies. Because incumbent technology companies held substantial patent portfolios in well-developed technology, the new companies had to focus on less-proven—thus, more innovative—markets. Moreover, government funding generally fell in peacetime. This required the young companies that had been working on government contracts to be able to reinvent themselves to address the commercial market, or perish. Finally, in an effort to attract additional defense spending, Stanford established the Stanford Research Institute, which conducted defense-related research and helped local businesses enter these markets.

Throughout this section, we have seen how government programs can go awry in their efforts to create a venture capital ecosystem. Yet the development of Silicon Valley, which occurred in both pursuit of and reaction to government policies—particularly, defense spending—suggests that government can play a useful role. Silicon Valley created a venture ecosystem out of necessity, but in the next section, we explore what research and observation has demonstrated to be effective and how these dynamics play out.

# 3.

## WE'RE FROM THE GOVERNMENT: WE'RE HERE TO HELP

Government does have an important role to play in creating a venture capital ecosystem. It can contribute in three distinct but linked ways: creating an ecosystem that encourages entrepreneurship and venture capital; ensuring that the program reflects the needs of the market; and revising it as necessary. The programs may address any of the three players in the private equity world: the entrepreneurs in whom venture capitalists wish to invest; the limited partners who invest in the venture capitalists' funds; and the venture capitalists themselves. Some governments have implemented policies addressing one, two, or all three of these factors. The fundamental principles of an effective policy to stimulate them remain the same.

Government efforts to create a venture capital ecosystem can focus on increasing the demand or the supply for venture capital funding. By creating a more hospitable environment in which entrepreneurs and venture investors operate, programs can increase the demand for venture capital. Increasing the supply can happen by improving the environment for limited partners who need to be confident that the "rules of the game" will remain roughly constant for the 10-year duration of their typical fund commitment. It can also occur in programs through which the government directly funds early stage projects. This last appears to exert a siren-like attraction to politicians and bureaucrats; the urge to fund companies directly is almost irresistible. It is possible that examining exciting new technologies is more fun than tinkering with the tax rates on long-term capital gains. The cynic may suppose that such direct intervention allows greater scope for self-interested program development than the others.

But the creation of an environment that is conducive to entrepreneurship and venture capital investment is critically important. Venture capitalists have to invest in companies and management teams, and without the basic building blocks described below, there will be little activity. We will call this first element, "Setting the Table," as it creates the environment in which the activity occurs.

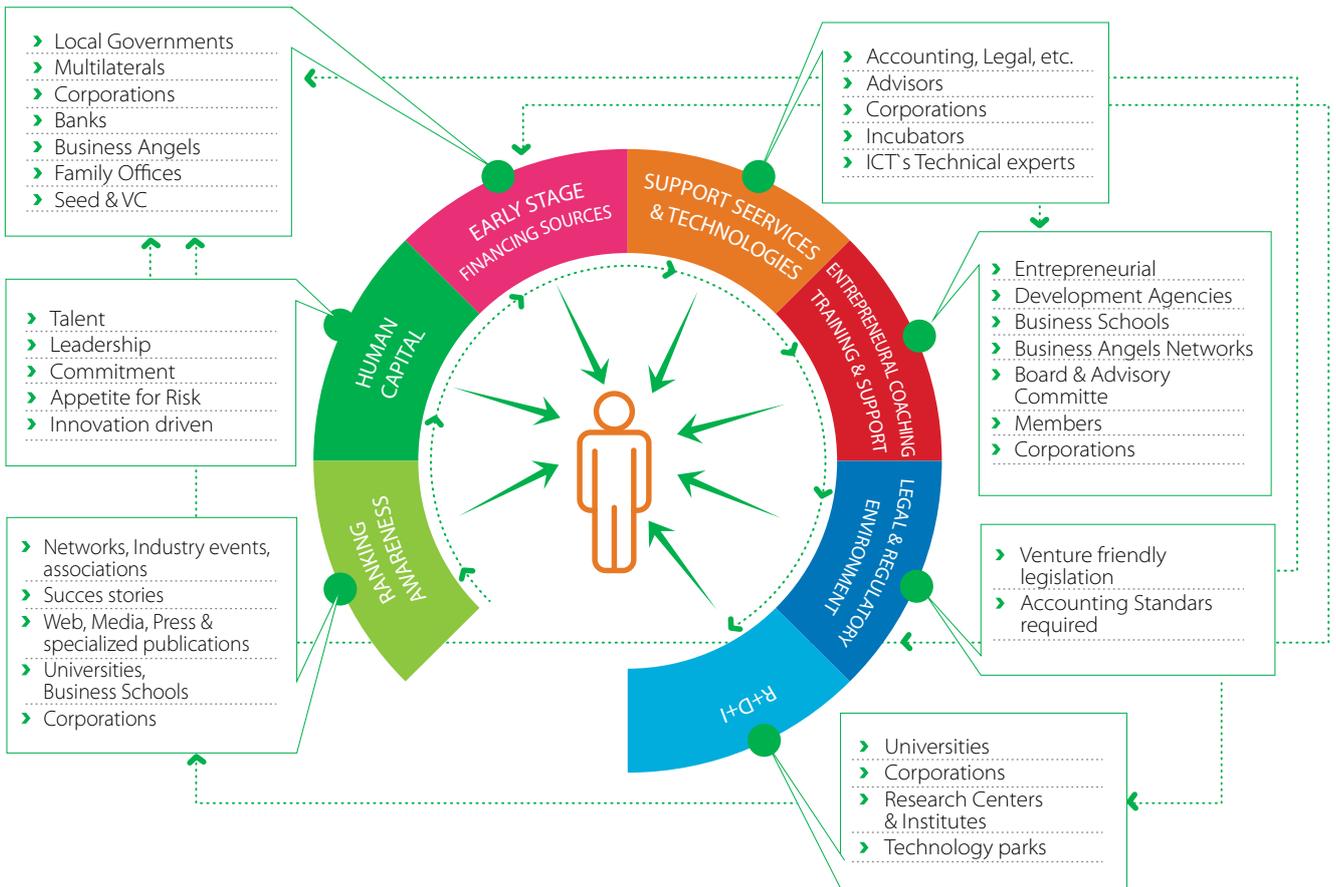
# A. SETTING THE TABLE



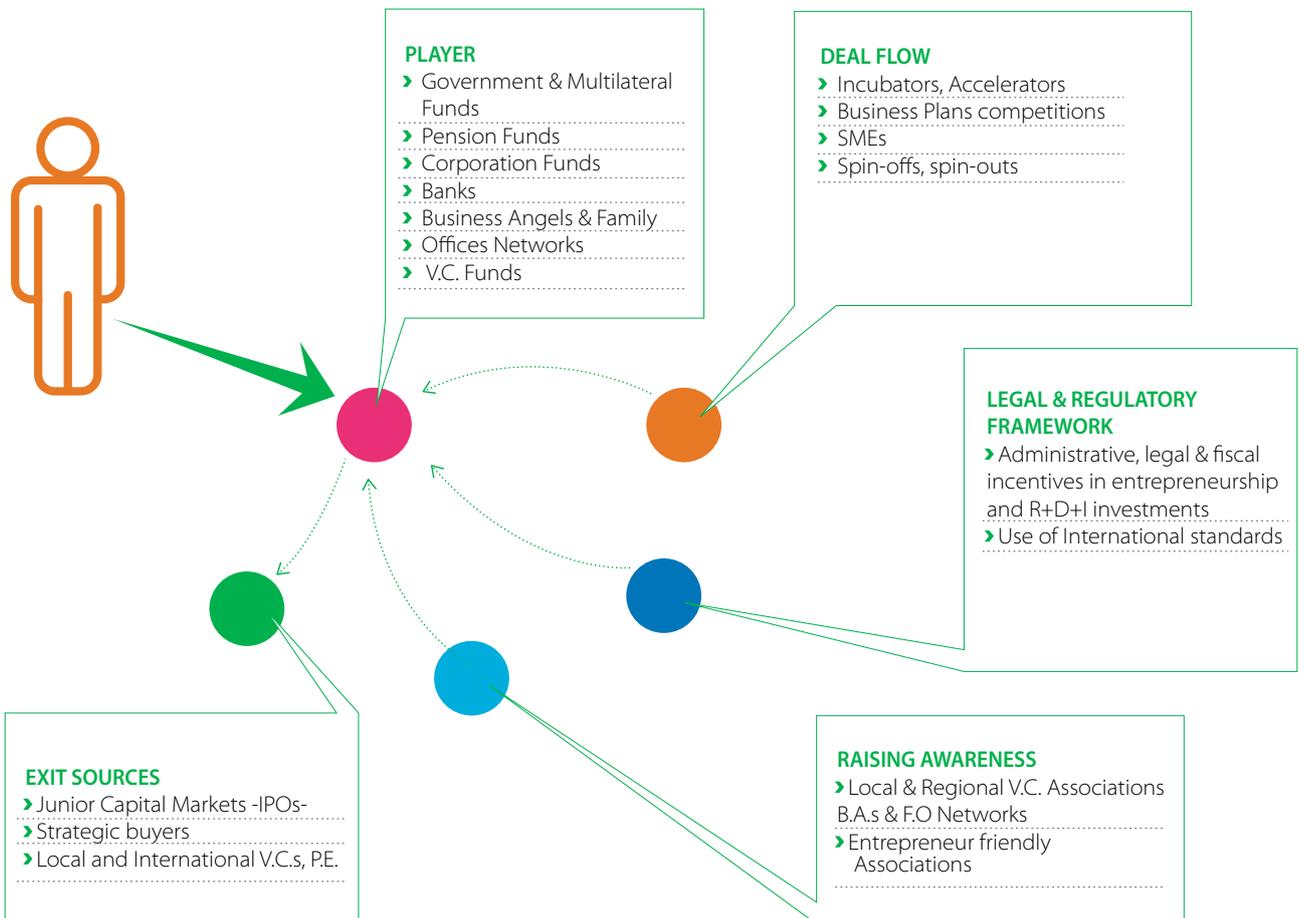
The figures that follow provide an overview of the many characteristics of an entrepreneurial ecosystem and a venture capital ecosystem. It is obvious that entrepreneurs and venture capitalists need each other, and thus their ecosystems share many of the same qualities. For the entrepreneurs, an awareness of entrepreneurship as an option, along with supportive social attitudes encourage their choice in the first place. Training and research and development resources are also important, as is a favorable regulatory regime. In many countries, for instance, bankruptcy is forbidden, which threatens to burden an unsuccessful entrepreneur with crippling debts and, often, social stigma. In addition, support services, a deep talent pool, and early financing options help bring a young company to maturity. For the venture capitalists, awareness of and familiarity with venture capital among the entrepreneurial community is very important. Supportive regulations are critical. In addition, support from the local regulators and limited partners, along with local deal flow from talented entrepreneurs, larger companies undergoing spin-offs, or incubator programs provides investment opportunities. Finally, there must be avenues for exit, such as public market listings, strategic buyers, or other private equity firms who will purchase the company. In their article on the determinants of venture capital activity in different countries, Leslie Jeng and Philippe Wells found that initial public offerings were the most important—in part, perhaps, because the precursors for a vibrant market for the initial public offerings of small, high-growth companies subsumes many.



**FIGURE 3** Elements of the Entrepreneurial Ecosystem



**FIGURE 4** Elements of the VC Ecosystem



# EFFORTS TO ENABLE ENTREPRENEURS AND VENTURE CAPITAL CAN BE GROUPED INTO FOUR FAMILIES:

## 1 Enacting favorable laws.

The importance of a favorable legal structure is easy to under-estimate, or discard in the view that it matters only in the litigious United States. On closer examination, however, laws can govern many aspects of the venture capital industry, from protections given limited partners through compensation for employees to deal structures. Some of these contracts can be very complex, even for start-ups with few assets and negative cash flow.

The very structure of a venture capital partnership is governed by law. The limited partnership offers the critical benefit of restructuring the investors' liability. If a start-up fails, the investors will lose the money they have invested but, in general, disgruntled employees will not be able to pursue the investors for further damages. With losses limited to invested capital, the possible gains from a successful enterprise look attractive indeed. As the venture capital saying goes, "You can only lose 100% of your money. You can have 1000% gains." While clever venture capitalists have figured out ways to organize when limited partnerships are outlawed, none of these structures have the benefit of both limited liability and a restricted lifespan. For limited partners, a restricted lifespan means that at some point, the general partners will have to wind up the fund, exit the positions, and return (at least some) of their money.

The legal regime also controls the type of security that private equity groups can use for their investments. As opposed to the preferred stock typical of most developed markets, through which investors are returned their invested capital before the proceeds are divided among the owners, private equity investors in many emerging markets use common stock. In part, this reflects legal norms: several countries, especially in Asia, do not permit different classes of stock with different voting powers. As a result, investors must seek other ways in which to control the company, usually by owning a larger proportion of the common stock.<sup>29</sup> An additional challenge can be that even when the government authorizes securities such as preferred stock, the judiciary and the entrepreneurial community may be unfamiliar with it. Without well-defined legal rules and effective court understanding and enforcement of complex deals, investors may have difficulty prevailing if taken to court if an entrepreneur decides to litigate an "unfair" outcome. General sentiment and precedent may lead to a ruling against the investor, even though recent laws would find on the investor's behalf. The importance of legalizing the use of standard contracts with such protections as preferred stock and contingencies like milestone payments and antidilution rights (which protect investors should the company under-perform and raise additional money at a lower price per share, thus diluting the earlier investors) is shown in a study that found that the survival of firms investing in emerging markets was directly linked to their use of preferred stock.<sup>30</sup> Moreover, an effective legal system appears to have a direct impact on the outcome of private equity investors: firms in such countries have average return multiples 19 percent better than the typical fund by sector and year established, while those in other countries fared 49% worse than the benchmark.<sup>31</sup>

Also part of the regulatory climate is the existence of a functioning and transparent stock market. Protection for minority shareholders is critical, whether they are private investors or those holding public shares. Clearly articulated (and enforced) listing and reporting requirements are critical. Another important aspect of the public markets is the existence not just of a national exchange on which large companies list but a local or regional secondary exchange, along the lines of London's Alternate Investment Market or the NASDAQ in the United States. This reflects the importance of exits to private investing. Initial Public Offerings (IPOs) are often the highest profile exit option for private investors and can play an important role in creating role-model companies that inspire other entrepreneurs to take private investment and create high-growth companies. In addition, even though the majority of exits occur via trade sales (to other companies), the possibility that the company might go public represents an alternative that inspires the potential acquirer to offer a more generous price than it might were there no alternative.



## 2 Ensuring access to cutting-edge technologies and technologists.

Another important contribution government can make to a healthy VC ecosystem is ensuring access to new technologies. This involves easing technology licensing for government-funded research emanating from universities. It also includes the ability for domestic firms to import machinery or code from other countries. Due to draconian customs rules, some biotech entrepreneurs have been known to have to wait months for shipments of reagents and other essential inputs. In the high-speed world of research, the loss of several months can be devastating.

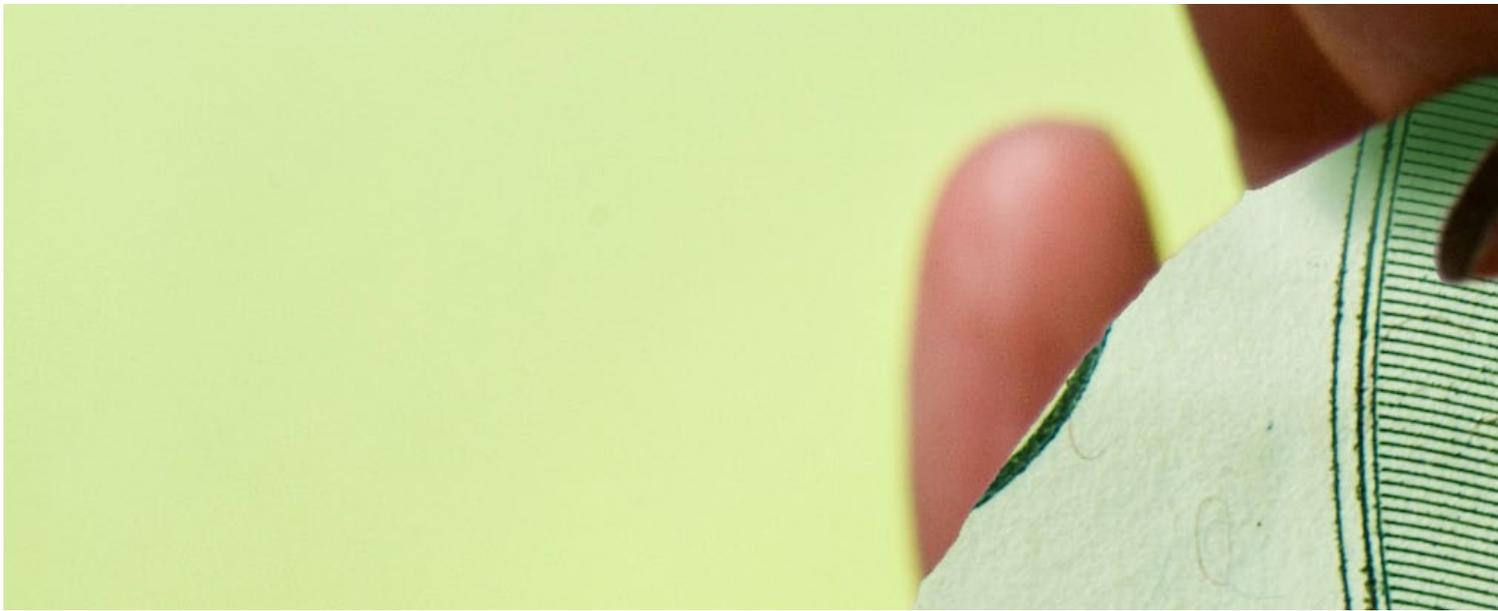
The movement of people is also important. Since the 9-11 attacks, foreign students and high-skilled workers have found it more difficult to enter the United States. This may prove destructive to the country's entrepreneurial spirit—between 1995 and 2005, 25% of the science and technology companies founded in the U.S. had a foreign-born CEO or chief technologist. In 2005, these companies generated \$52 billion in revenue and employed 450,000.<sup>32</sup> Most of these founders did not enter the country to start jobs but to study and only found themselves entrepreneurs unexpectedly – but with terrific results for the economy.

Even domestic labor laws can have an important role in creating a VC ecosystem. Countries with more restrictive labor protection laws have less VC investment because the investors and entrepreneurs cannot react as flexibly as required.<sup>33</sup> High-growth companies move through phases of development: when they are designing products, they need many engineers but once the product has been perfected, the company may need fewer engineers or engineers with different talents to work on a subsequent product along with more marketing people. Therefore, some engineers naturally lose their jobs at the given company and will move to another. During acquisitions, some employees are made redundant (no company needs two CFOs, for instance). If the company is required to retain such workers or to pay punitive separation agreements, the investors and founders will naturally be less willing to take the risks of founding or funding the enterprise in the first place. It is also important that society accepts a career path that involves many different positions at young companies.

Not only does this apply to hiring and firing but also to the enforcement of the non-compete agreements that accompany many entrepreneurs when their companies are acquired. In the U.S., those states with less stringent enforcement of non-competes have more start-ups and appear to attract more tech stars.

In a healthy VC ecosystem, then, people may not work at the same job for their entire lives but there will be lots of high-growth opportunities at which they can work.





### 3 Creating tax incentives or removing disincentives.

Taxes operate on two ends of the private equity scale: supply or demand. Supply-side taxes are those that affect the LPs who invest in private equity funds. Many of these institutions, though, are pension funds, endowments, Development Finance Institutions (DFIs), which are already tax exempt. Hence, such changes affect only taxable institutions such as corporations and high-net worth individuals and have a muted effect.

The demand-side impact of tax changes for entrepreneurial activity, however, can be substantial. When long-term capital gains tax rates in the United States fell during the 1980s and 1990s, the willingness of entrepreneurs to leave the relative safety of corporate jobs where income was taxed at the individual tax rate of (roughly) 35% increased markedly.<sup>34</sup> It also increased the interest of individuals to found VC firms, as the risks were more dramatically offset by potential rewards. Nor is this unique to the U.S.; research has found a similar dynamic in Europe.<sup>35</sup>

### 4 Training and encouraging potential entrepreneurs.

While there are certainly a number of gifted natural entrepreneurs, entrepreneurship can be taught and learned. In essence, it can become a habit of thought. And with the proper incentives in terms of taxes, as noted earlier, it can become a lucrative and stimulating career path.

Singapore may have created the most comprehensive approach to fostering entrepreneurship and culturally embracing risk-taking. The success of its strategies ranges, but the scope of the effort is worth noting. For instance, in five years, the government increased funding for academic research—funding for the National University tripled in five years. In addition, support for entrepreneurial activity within the universities rose. Other agencies supported networking groups and provided grants for start-ups to hire consultants. The country's sovereign wealth fund invests in global venture capital funds, establishing relationships that may prove useful. The Ministry of Manpower and other groups help expedite visas or other permits for foreigners who want to establish a high-growth business in Singapore. National competitions and events promote entrepreneurship and identify promising individuals and concepts.

Other countries are trying their own approaches. Later in this report, we will explore Chile's efforts to stimulate entrepreneurship by encouraging the arrival of foreign investors and Brazil's efforts to help entrepreneurs understand the attitudes of VC investors and the realities of operating a high-growth business.

Another aspect of encouraging entrepreneurship is removing the stigma of failure. Singapore's Phoenix award celebrates an individual who went from a failure to a success. In other countries—some of them developed—declaring bankruptcy is ruinous to the entrepreneur. Sometimes they are barred from ever starting a business again, thereby preventing them from applying the lessons they have learned at such expense.



## 5 Conformance to international norms.

Major private equity investors operate globally. They invest where the opportunities are best—and where it is easiest and most familiar, as shown in research on home-country bias.<sup>36</sup> It is thus important that an emerging market provides a familiar setting in which the firms can invest.

Some might argue that if a country is large enough, it needn't worry about what the international players think; that the domestic industry is sufficient. But international firms have played an important role in a number of emerging markets. While DFIs such as the Multilateral Investment Fund can help transfer the knowledge of best practices, the demonstration effect of top tier private equity firms is profound. Their experience and resources can also help build a depth of knowledge on the ground. Once the firms decide to set up local offices, they generally hire at least some domestic practitioners, thereby increasing the local knowledge base. In addition, their knowledge of such things as listing procedures on developed markets and their networks among other experts can dramatically help a young company succeed.

To attract these players, a country must have “set the table.” Tax and regulatory regimes should be compatible with international norms. Even the appearance of irregularity can dissuade them from establishing a presence in the country. One might observe that China's regulatory regime is not yet consonant with international norms, but China's potential is such that it is granted more leeway than many other countries.

Another concern is the availability of timely and reliable data. Investing in emerging markets—especially over the four-to seven-year timeframe of the average VC investment—is a risky endeavor. Investors seek some sort of reliable data, ideally on the economy. The presence of a local venture capital association that collects industry data and can advocate for the asset class is also attractive. A government program that supports the establishment of such an association can provide an effective accreditation to the fledgling group and give the program itself a “quick hit” to show that it is making progress. Furthermore, transparency around everything from opening a business and hiring workers to accounting rules and stock market listing regulations is critical.

Expatriates represent another constituency that can be attracted by a country with a VC ecosystem that conforms to international norms. Every country has its Diaspora, often the “best and brightest” who left to be educated in developed markets and gained important experience. Such individuals are often eager to contribute to the development of their home country. This can take many forms: angel investors; mentors or champions of local venture capitalists; or advisors to policy makers. Some wish to start companies or investment firms themselves. They bring a network of international contacts along with their experience that can uniquely benefit both the industry and the country—but only if they see a situation in which they can thrive.

## B. LISTENING TO THE MARKET



Setting the table is the first step. Such an exercise ensures that the environment is correct for the investors, the entrepreneurs, and the LPs. Many policy-makers, though, become enthralled by their own vision and fail to listen to the market's messages. These messages are twofold: what the market wants and what it doesn't.

The first item to note is that if the market is already doing something, the government is probably well advised not to. All too often, government programs have eagerly invested in just those sectors that are popular with the market too. This dynamic yields either of two results: the government program invests in those opportunities that are unattractive to private investors or the government program invests in everything it can find, crowding out private investors. We saw an example of this last dynamic in the U.S with the above-mentioned cleantech program, where private VCs waited for the government to invest in a potential company before doing so itself.

Without feedback from the market, the taxpayers may end up with the equivalent of Malaysia's BioValley. In 2001, that country decided to boost its biotechnology capability by investing \$150 million in a technology park. Unfortunately, the effort's leaders did not consult biotechnology groups regarding their desire to locate in the BioValley. Malaysia had little domestic talent to operate the facilities nor a national tradition of high-tech entrepreneurship. Moreover, the country sent conflicting signals regarding its commitment to the sector and the planning process was extremely opaque. By 2005, after only three companies had signed contracts for space in the BioValley (leading it to be called "The Valley of the Bio-Ghosts), the project was refocused to encourage more distributed projects among a larger number of sectors.<sup>37</sup>

Consider the message such policy gyrations convey to the entire country's entrepreneurial community. A scientist who might have thought of leaving a tenured faculty position to launch a start-up in the BioValley would be relieved that he hadn't taken such a risk with his and his family's future. An investor would be relieved that she had not invested in an enterprise with such little staying power. But the fundamental problem was that the policy makers did not consider whether biotechnology was a good fit for Malaysia. Were Malaysia's universities known for creating biotechnology break-throughs? Did the country possess a tradition of high-tech entrepreneurship? Simply because Singapore had a Biotech park (the Biopolis) was not reason enough to suppose that Malaysia would succeed at such an effort. In fact, the presence of that operation in Singapore might have suggested that the demand for high tech biotechnology research facilities in the region had been met. Malaysia might have been better served to spend its millions on projects that better matched the country's unique resources, whether technology involving palm oil or petroleum.

The best way to avoid such problems as the empty buildings in the BioValley is to seek matching funds from private investors. The government might have gone to biotech investment firms and biotech researchers and asked what they needed to develop a world-class industry. If the government then offered to pay only half of the expenses, reality sets in. Dreams then become scaled back and targeted to meet the needs of the market. Furthermore, requiring matching funds tests not only the market's desire for the program or services but also the potential of the technology or investment firm. The entrepreneurship program attached to a U.S. university located to the north of Boston realized that it routinely lost biotech start-ups to the city due to the availability of specialized research labs for rent there. The university developed its own research lab space that it rented to start-ups at market rates. Such a policy serves as a market test: does the company have enough funding or enough belief in its own product that it will pay market rate rents? If not, one might question its future success.

It is important that the matching funds come from truly private organizations. In some countries, the government has close links with certain sectors to which it has granted lucrative monopolies often on natural resources. A national program might stipulate that certain funds raise half their capital from private sources, only to have the government encourage these groups to participate. The validity of such a market test can be questioned.

A number of matching mechanisms have been developed. A number of them, such as those used in Israel's Yozma program, the New Zealand Venture Investment Fund, and Brazil's INOVAR Seed Fund program, require a certain percentage match from private investors but the government caps its own returns. This strategy increases the pool of returns to be split among the other investors and the GP. The particular power of this structure is its boost to the reward in the risk-reward ratio, while still ensuring that private investors are willing to risk their money. The government focuses on its goal, which is increasing the amount of venture (or seed) investment in the country, stimulating innovation and entrepreneurship, and increasing the experience of all players with the asset class. The social externalities that result from encouraging venture investment in this way outweigh the financial gains that the government would have garnered.

In addition to matching funds, though, there are other types of matching programs. These include loans and quasi-loans, such as are used by the Small Business Investment Corporation in the U.S., and loss guarantees, as have been used in Israel and Germany. These both introduce some incentive issues.

Loan programs often founder on the very risks they are supposed to allay. High-growth entrepreneurial businesses usually have trouble getting funding because of their high risk profile—that is, many of them fail. The rule of thumb with venture capital in the United States is that 30% of the investments will fail completely; 40% will return capital, and 30% will provide “venture returns”, which are estimated at roughly 17%-22%. Note that these are companies that have passed the stringent review of a venture capitalists' due diligence process and also had the benefit of hands-on monitoring and advice from experienced investors who have their own money at stake. Companies not chosen by venture capitalists—such as those who receive government loans—may be even less likely to succeed.

Another incentive issue for government loan programs often involves their design—the rate of return to the government is usually capped, while the program shares the entire risk of loss. In such a situation, the program has all the returns of debt (that is, return of capital plus interest) and much of the downside of equity (the loss of much or all of the loan amount). With the limited gain, there is therefore less incentive for the policy-makers involved in the program to examine or monitor the programs.

Moreover, loans to start-ups have a built-in difficulty. Venture capital investments can be described as “money with strings attached.” The strings are the presence of the venture capitalist on the board and his ability as part of the deal's structure to make changes to the company's strategy. Bank loans have no such additional powers. When a company gets into trouble, a banker wants to call the loan before all the money is lost, rather than restructuring the transaction to give the company a better chance to succeed.

Loan guarantees are a different sort of program. They are often extended to banks who lend to the companies in question. Success relies on the ability to find successful companies that would not otherwise have been funded. Banks have a different set of skills—as-

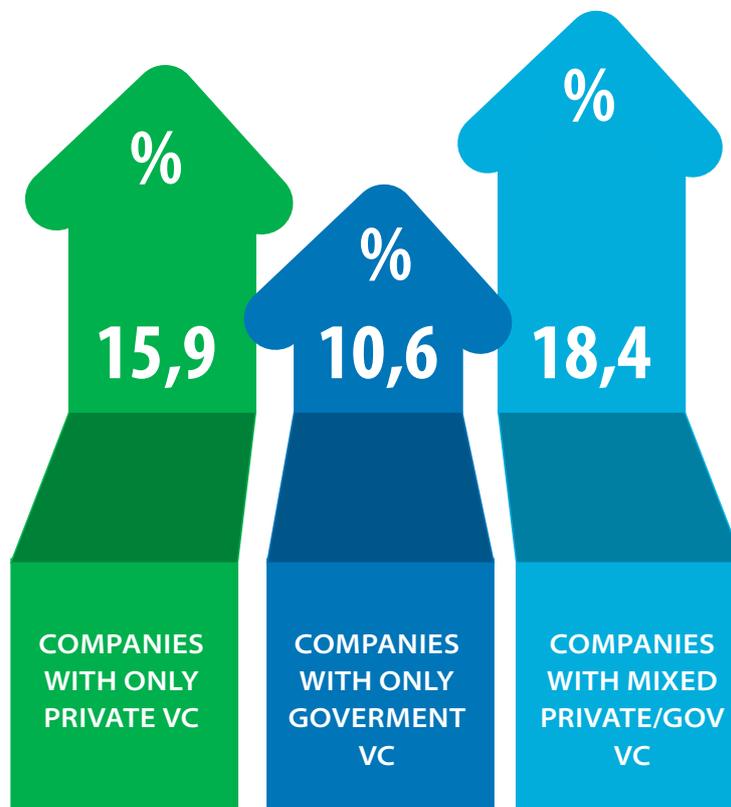
sessing credit worthiness is far different from selecting and advising high-tech, high-risk companies. In addition, introducing a third party to the program (the bank that selects the companies) adds the concept of moral hazard, in which an entity that is making a decision does not bear the full brunt of its consequences. Thus, a loan guarantee program relieves the bank from the full cost of choosing a poor investment and may therefore reduce the amount of scrutiny given to a company in that program. For instance, one study found that the four-year failure rate for small companies went from 9% if the entrepreneur did not participate in a French loan guarantee program to 21% if it did.<sup>38</sup>

If loan guarantees are somewhat problematic, loss guarantee programs are even more so. These programs make up some proportion of the losses suffered by a fund or an investor. Not only does this raise questions about incentives, but once again, one might wonder about the attention given to investment selection and monitoring by investors that

would be attracted by such a scheme. The difference between loss guarantees and matching funds with capped returns is starkly depicted here: in the matching fund program, the investors receive extra shares of the rewards, while with loss guarantees, they are compensated for their losses.

The impact of a mixture of private and government-sponsored VC investment is shown in Figure 5, Exit Rate. Using a sample of 20,446 enterprises in 25 countries that receive venture capital funding between 2000 and 2008, Brander et al. explored the impact of investment from different types of venture capital firms: government-associated venture capital firms alone, private venture firms alone, and the two mixed.<sup>39</sup> Companies that received investment from a mixture of private and government VC entities, they found, tended to receive more capital and exit with higher returns than did those backed only by private or by government VC groups. The privately funded companies out-performed those funded only by government operations.<sup>40</sup>

**FIGURE 5** Exit Rate



**SOURCE** Brander, Du, and Hellman, 2012



As demonstrated in the prior findings, it appears crucial that outside investors and fund managers should have some amount of their own money at risk. Not only does this become a matter of financial return, but it also has a reputational aspect. Fund managers that are trying to prove their worth and create returns for themselves, their LPs, and others have “aligned interests” and can be expected to work very hard indeed. Some first-time fund managers in emerging markets may have exhausted their own resources simply establishing the operation and have nothing to contribute. Such a situation can lead to misalignment of interests between the managers, who are desperate for an early return, and the LPs, who want long-term value creation. One of the lessons learned in the MIF’s early stage investing is the importance of choosing first-time funds that are managed by professionals whose success in prior endeavors will support their current efforts.<sup>41</sup>

Matching funds have undeniable power but only as long as the private sector is willing to supply the match—that is, that private groups perceive an opportunity in the market and agree that the government’s participation is sufficient to make the market interesting. If the opportunity is not seen as attractive at all, the private sector will not be interested regardless of the government match. In that case, the government must decide whether it is reasonable to try to resolve that particular market failure. It may be that the program is ahead of its time, or that it simply does not fit the needs of the market. Examples of this in LATAM have been government-sponsored real estate funds or the funds that the Mexican development bank created for specific states that never reached first closing due to lack of interest by other investors. In creating such a structure, the government is seeking—and receiving—important feedback that can allow it to allocate its scarce resources to efforts that are more relevant to the market.

# C. PAYING ATTENTION TO THE DETAILS



Getting the details right is perhaps the least glamorous part of creating the ecosystem. It involves research, talking to different parties, keeping a finger on the business pulse. A reliable set of macro economic data helps tremendously in this effort, as it allows the policy-makers to track changes over time. Simply being able to track new business registrations is important, and surprisingly difficult if a tax regime encourages entrepreneurs to register many small businesses in order to shield gains or qualify for various incentive schemes. A domestic venture capital association can track investment, fund-raising, and exits, and also offers the government ministers a view into the opinions of the players. Tracking the details rewards those who have sown the seeds for the ecosystem.

Many of the details have been mentioned already. For instance, it is important to get the program's size right. Too small and it fails to make an impact. Too large and it crowds out private investment or provides such a flood of money that local investors cannot manage it wisely. Providing money all at once with the stipulation that it must all be invested in a certain amount of time, for instance, is a deeply suspect strategy. While it avoids the possibility that incoming administrations might change the strategy, it forces an artificially large amount of capital into a market that is rarely prepared for it. The firms that are called upon to invest it must do so all at once and therefore lose the chance to learn from early projects or take advantage of "time diversification," or the opportunity to invest at different points of the business cycle. The adage, "a rising tide lifts all boats" is true for VC investing and it is easier to provide good returns if the macro-economic indicators are positive. This is by no means to argue against investing during market downturns—some argue that proportionately more VC-funded companies founded during downturns are successful—just that time diversification is an important contributor to success.

Paying attention to the market's messages, as noted earlier, and ensuring that incentives reward participants if they meet goals are also important program aspects. The first, an attitude in the U.S. called "If you build it, they will come," was seen in Malaysia. It is also seen in a number of projects that tried to focus venture capital investment into undesirable sectors or regions. The discussion of loan loss guarantees further emphasizes the importance of the right incentives. This is the reason that some VC firms encourage their general partners to co-invest in the firm's deals. Noted one GP with coinvestment privileges, "My \$4,000 may not be as much as the fund's \$4 million, but it meant a huge amount to me because it was my money. So I was dedicated to making that deal a success."

Periodic evaluation of the program is essential. Such assessments are rare especially if a program is successful. But a program that succeeds in meeting a market need today may be superfluous once the market is functioning smoothly. As we noted in the Capture discussion, an entire agency can grow up around the program and make it impossible to change. Evaluation need not call for a wholesale revision of the program but instead discern best practices and allow better performing managers to share their knowledge with those who are struggling.

In seeming contrast to the recommendation of periodic evaluation, it is important that the program be seen to have staying power. Social changes in attitudes toward entrepreneurship occur over time. Venture capital success occurs only slowly. The life of the average VC fund is 10 years, which is more than twice the typical term of many elected officials (it is five times the term of a member of the U.S. House of Representatives). The difficulty thus becomes that a policy enacted under one electoral regime often extends far beyond it, meaning that future funding may depend on members of another party. In addition, expenses incurred under one party's majority may yield successes for a later one. In our exploration of Brazil's INOVAR policy, we shall see how one project was protected from short-term political gyrations. This reflects the earlier concern about the short-term/long-term dichotomy that can occur in VC policies. If the market sees widespread commitment to a policy, the players will be more willing to assume the risks involved in developing new skills. Changes in the program should be gradual and announced, rather than rapid shifts in direction.

One of the challenges faced by policy-makers is whether to strengthen domestic players or attempt to attract global firms. The global firms bring a stamp of approval to a market when they begin investing in it, yet the local groups may be more likely to succeed due to their greater knowledge of the local environment. In the end, the two types of firms may be highly complimentary: local groups can become niche players who coinvest with and learn from global operations. The presence and vitality of both however, depends on strengthening the fundamental environment in which the industry exists—an entrepreneurial ethos, a set of LPs willing to invest, a strong group

of investors. These in turn depend on transparent and predictable regulations, exit methods, and incentives that inspire the actors to work toward the desired outcome: a healthy VC ecosystem. The risk, of course, is that global players attracted by subsidies might leave when the subsidies end. This is reasonable, of course, but the subsidies would have to be significant indeed to convince global firms, faced with a plethora of options, to accept the opportunity costs of not pursuing more attractive deals in other countries. Global VC firms are unlikely to enter a market simply in response to subsidies; in general, there must be the potential for genuine opportunity. Global firms have been known to set up offices in emerging markets only to shutter them when the overall economy slows or opportunities diminish (this was particularly true in the 2008-2009 downturn, when Eastern Europe's private equity environment struggled and some top-tier firms closed recently opened offices)<sup>42</sup>

It is also important that standard market signals persist, regardless of the firms policy-makers are trying to attract. Firms must be allowed to invest where the opportunities are most attractive, not in the regions that are deemed in need of investment. Efforts to constrain VC investment to regions that are in economic decline have been found to have little impact: despite substantial amounts of government money, the regions still decline. Often this stems from a mismatch between the existing skills base (for instance, agriculture or heavy industry) and the skills in innovation, technology, or entrepreneurship necessary to create the types of high growth companies that attract VC investment. But also VC firms are staffed with very bright individuals who can think through the requirements of a particular subsidy scheme such that they receive the subsidy regardless of whether they provide the desired result. Alternatively, they simply view the reward as insufficient for the risk, cost, or inconvenience and decline to participate.

# 4.

## SOME CASE STUDIES FROM LAC

Presented below are three brief summaries of programs in which policy makers addressed the needs of the venture capital industries in their countries. INOVAR in Brazil, Mexico Ventures in Mexico, and the Start-Up Chile program in Chile all addressed needs in the local venture capital market. All show how a government can address the challenges described above by carefully setting the table, listening to the market, and paying attention to the details.



## FINEP/INOVAR<sup>43</sup>

Brazil is the most significant player in private equity in the LAC region, and receives the vast majority of funds raised. While its mid- and later-stage private equity ecosystem has been thriving, its early stage sector—apart from a few tenacious firms—has struggled. This had been a persistent issue and in 1999, the Brazilian Agency for Innovation (FINEP)<sup>44</sup> identified a number of noteworthy gaps<sup>45</sup>:

- 1 There were very few domestic VC fund managers with any significant track record.
- 2 Local pension funds were unwilling to invest in private equity, particularly venture capital. In 1999, Brazil's private pension funds alone had US\$70 billion under management (13.5% of GDP), but very little invested in private equity<sup>46</sup>.
- 3 There was no national organization for private equity firms to share lessons they had learned or to lobby for regulatory change.
- 4 There was no effective bridge between investors and SMEs. It was difficult for SMEs to find GPs that might be interested in investing, and when they did so, few GPs had the skills to assess the opportunity. Moreover, few entrepreneurs were comfortable with active, equity-owning investors.
- 5 The regulatory and legal framework for on-shore VC and later stage investments needed development.
- 6 Exits from VC investments almost always occurred through strategic or trade sales as the market for Initial Public Offerings (IPOs) was limited. Between 1995 and 1999, Brazil's main stock exchange, BOVESPA, had four IPOs<sup>47</sup>.
- 7 Few companies regardless of their size, were familiar with private equity as a financing vehicle.

The Inter-American Development Bank's Multilateral Investment Fund (MIF) and FINEP shared an underlying concern that without a healthy early-stage private investment ecosystem, innovation and innovative companies would wither, harming Brazil's long-term economic prospects.<sup>48</sup> The two organizations teamed up. For FINEP, an association with the MIF, which had been active in Brazilian venture capital since 1994, brought domain knowledge, specialized skills, and, because the MIF provided multi-year grants, a sense of permanence. The support of a supra-national, non-political group like the MIF helped preserve the effort over the time horizon necessary to establish a long-term investment program.

To achieve the goal of helping small- and medium-sized companies (SMEs) gain access to capital while encouraging the creation of new VC funds and fund managers in



Brazil, the organizers had to address almost all parts of the VC environment simultaneously: entrepreneurs needed to be trained in raising money and what to expect from VC investors; fund managers needed to be trained in raising and managing funds, assessing investment opportunities, and managing portfolio companies; and potential limited partners—particularly the pension funds—had to learn how to do due diligence on funds.

Designing the project took almost two years and involved careful consultation with players in the market. The effort focused on both innovation and return, learning from the MIF's awareness that VC funds would not function without a focus on returns. The project recruited two other partners: Sebrae, a public-private partnership that focused on supporting SMEs, and Petros, the pension fund of Brazil's national oil company, Petrobras, and the largest such group in the country.

Initially-- before the Program was in place and fully funded-- the FINEP team addressed projects that required little money, such as founding ABVCAP, the Brazilian VC Association. The team also held the first Venture Forum to educate entrepreneurs and general partners on the details of the asset class. As the program received its funding, the group created a website to share information about VC and the INOVAR program, along with registration information for the various programs.

The other parts of the INOVAR program included<sup>49</sup>:

**1 INOVAR Funds Panels:** Also called a Technology Investment Facility or the INOVAR Incubator, the program created a structured process that assembled a consortium of investors (the INOVAR Funds Panel) who jointly analyzed and performed due diligence on VC funds. GPs learned how to present their funds and LPs learned how to assess them. Written assessments sent to the GPs provided feedback on their fund proposals, which helped the entire industry evolve.

**2 INOVAR Forums:** These forums provided education to both entrepreneurs and investors (usually GPs). Promising entrepreneurs received training on fundraising and preparing business plans to present to potential investors, which also received education about the asset class through the program. Segmented according to company stage (seed, venture, or pre-IPO), the companies could interact with potential investors, present their business plans, and if successful, start to negotiate a deal.

**3 VC Training programs:** These sessions created local capacity by educating local GPs and investors (mainly pension funds) on best practices and due diligence issues.



INOVAR II, established in 2007, adopted a new goal of stimulating seed-stage investors and angel funds. The angel programs brought angels together for workshops on best practices and helped them create networks. FINEP declined the request to provide funds for the angel networks, though, believing that this was not its proper role.

The seed stage funds provide a clear example of listening to the market in terms of adjusting the details of a program: Initially, the Seed Funds program sought to invest in funds that had raised 40% of their capital from local investors (usually agencies of some sort) and 20% from private investors (usually angels). FINEP would invest up to 40% of the total and offered a “money-back guarantee” of up to 20% of their commitment to the private investors in case the fund lost money. Although the program did attract some funds, finding local agencies willing to contribute the required 40% was difficult and the structure with unseasoned general partners investing in brand new companies was riskier than many investors were willing to accept.

The program was revised in two ways. First, the requirement for local agency backing was dropped. The “money-back guarantee” on 20% was maintained but private investors had to provide 30% of the total capital. INOVAR/FINEP<sup>50</sup> would provide up to 70% of the fund, but no more than R\$35 million (approximately US\$20 million). The total fund size had to be at least R\$25 million (approximately US\$15 million). Secondly, FINEP agreed to reduce its returns and take only invested capital and the hurdle rate (preferred return) on up to 50% of its investment in the fund. This increased the returns for the manager and the other investors. With the new structure, three funds have been founded, with the largest at R\$80 million (US\$47 million) and the others in the vicinity of R\$50 million (US\$30 million).

Finally, in an attempt to raise the profile of groups that used best practices, FINEP launched the INOVAR awards in 2009. These were given in three categories: Best Governance (on the fund level), Best Team (on the fund level) and Best Deal, and were decided by the INOVAR Investors.

## RESULTS

Between its debut in 2001 and the end of 2011, INOVAR had made considerable progress in addressing the gaps initially identified in Brazil's ecosystem. From the initial four partners, of which one was a pension fund, INOVAR had 17 partners, 11 of which were Brazil's pension funds. The top five pension funds were all partners. More than 220 fund proposals had resulted in over 110 processes of due diligence. FINEP selected 24 funds in which it invested a total of R\$416 million (approximately US\$250 million). These 24 funds raised a total of US\$2 billion from LPs including FINEP, the MIF, INOVAR investors, and others.

Through the Forums, more than 56 companies had received roughly US\$55 million in seed capital and VC financing; 11 late stage companies had raised US\$1.4 billion. In addition to the Seed Forums, the Angel Workshops had attracted an average of 90 people per event, of which roughly half were individual investors.

To date, INOVAR has cost US\$13 million in operating costs and facilitated more than US\$1 billion invested in private equity (including VC) funds.<sup>51</sup> More than US\$2 billion had been invested in companies.

## B. MEXICO VENTURES

Another approach is that of Mexico. Like Brazil, the government sought to create a way to inculcate best practices in its domestic VC industry and to train Mexican managers and entrepreneurs. At the same time, the program was intended to raise the profile of Mexico as a source of good deals and innovation. Mexico's small percentage of private equity to GDP, roughly 25% of the region's average, gave it substantial room to grow.<sup>52</sup> As in many emerging markets, few domestic institutions invested in private equity let alone venture capital.

Starting in 2006, Mexico's four development banks transferred all of their commitments to private equity (fund investments, direct investments, and investments in Sincas, a domestic vehicle allowed to raise equity on the open market) into a specialized fund of funds, along with an additional \$250 million commitment. This group, the Corporación Mexicana de Inversiones de Capital (CMIC), had an independent and professional management team.<sup>53</sup> This first vehicle was called Fund of Funds Mexico I.

CMIC acts essentially as a fund of funds. Between 2008 and 2011, the organization invested \$273 million in 22 funds, of which two were Advent and Nexus. At the start of 2011, CMIC founded a venture capital fund-of-funds called Mexico Ventures I. It had \$80 million in commitments: half from CMIC's limited partners, primarily NAFIN, one of the development banks. The balance came from the Ministry of Commerce (\$30 million) and \$10 million from a multilateral institution.

Mexico Ventures I was co-managed with Sun Mountain, a U.S.-based fund of funds. It received back-office and advisory support from Greenspring Associates, which was also U.S.-based. The two relationships brought a clear private-sector sensibility to the operation along with exposure to best practices in accounting, due diligence, response to capital calls and the like. The networks of the two affiliated groups also provided increased exposure for Mexican deals to international and U.S. firms. "It's not that these firms have to invest in them," said one of the original Mexico Ventures I partners, "but they will take a look at them because they know the folks at Sun Mountain and Greenspring."

Like INOVAR, the program's design was the product of careful thought and market testing. The initial idea of a "Mexico only fund"—a Mexican group investing only in Mexican funds and opportunities—was substantially revised to expand the pools of investors, fund managers, and entrepreneurs that would be considered. The government's initial \$80 million contribution was to be matched with \$40 million from private institutions. The fund manager expertise increased through the collaboration with Sun Mountain, which owns 50% of the general partner, serves on the investment committee, and shares in the fund's economics.

Mexico Ventures has a two-pronged strategy. First, like a typical fund-of-funds, it seeks to invest in other venture funds targeting SMEs, regardless of their geography. Secondly, the firm will invest directly in companies. It hopes to invest in 7-10 funds and a similar number of companies. Since its founding, Mexico Ventures I has committed to funds raised by three U.S.-based firms: Mission Ventures, Sierra Ventures, and Sevin Rosen, and four Mexican fund managers. It has also made two direct investments.

An important aspect of the fund's strategy is the group's definition of success. Rather than a specific amount invested in a specific number of firms, Mexico Ventures seeks to catalyze the entire VC ecosystem in the country. As such, success is defined in two ways: first, by increasing Mexico's presence on the international VC stage in terms of foreign limited partners, entrepreneurs, and funds investing or doing business in Mexico. It is also hoped that more Mexican limited partners will invest in Mexican funds and more Mexican funds will invest in Mexican opportunities.

In addition, Mexico Ventures and CMIC in general have been trying to create an infrastructure around venture capital in the country. The group is trying to start a series of internships between U.S. students in Mexican funds, and Mexican students in U.S. funds, as a way to create networks and teach best practices. The group also wants to increase the amount of information available about the Mexican market, gathering and promulgating information on venture capital deals in the country, the general private equity environment, and the details of the industry. There is also a project to provide speakers on entrepreneurship to conferences at colleges and business schools.



CMIC started raising its second fund (Fund of Funds Mexico II) in March 2012. The differences between the funds are shown in Figure 6 below.

**FIGURE 6** Mexico Venture I and CMIC's Two Funds of Funds

Concept	Fund of Funds Mexico I	Fund of Funds Mexico II	Fund of Funds Mexico Ventures
Stage	Closed	New	New
Seed capital	No	No	Yes (Up to 10%)
Minimum fund size	20 MM	20 MM	12 MM
Early stage (Venture Capital)	Seldom	Seldom	Principally
Equity growth (Private Equity)	Principally	Principally	Seldom
Investment size	From 2MM	From 2MM	From 100K to 10 MM
Innovation oriented	Seldom	Seldom	Principally
Finance sector	No	No	No
Co-investments	Yes, with restrictions	Yes, with restrictions	Yes, no restrictions
Infrastructure and Real Estate sectors	Yes	Yes	No
Polluting companies, illegal activities, weapons and explosives	No	No	No
Risk-adjusted returns, as a key factor for investment decisions	Fundamental	Fundamental	Fundamental

**SOURCE** [www.mexicoventures.com](http://www.mexicoventures.com), accessed August 13, 2012

## RESULTS

By the end of 2011, Mexico Ventures I had committed \$22 million to four funds, including Sevin Rosen, Sierra Ventures, and Latin Idea III. It is too early to provide clear numerical results, but the program demonstrates many best practices. It was created with input from the private sector and even has private sector management. Individuals with private sector experience are running the program. The fund-of-funds structure provides expert review of investment opportunities, and the fact that the investee funds need not be Mexican further allows the effort to use market feedback in its evaluations. It is also encouraging that milestones such as “invest \$X million by 201Y” have not been established, as such metrics can have deleterious results by encouraging investment regardless of the prospects.

Mexico Ventures breaks new ground by focusing on early stage investments. The prior efforts had been much more geared toward growth equity. This reflects a natural evolution in a country's VC ecosystem: private investors feel more comfortable investing in more mature companies in a new market—the market itself is unknown to the investors and therefore risky. Investing in a company that has a proven market or product mitigates the overall risk. Therefore, over time, government programs should move down the scale and address the early stage opportunities and leave the later stage to the private investors.

THE GOVERNMENT'S INITIAL  
**\$80 MILLION**  
CONTRIBUTION WAS  
TO BE MATCHED WITH  
**\$40 MILLION**  
FROM PRIVATE INSTITUTIONS.



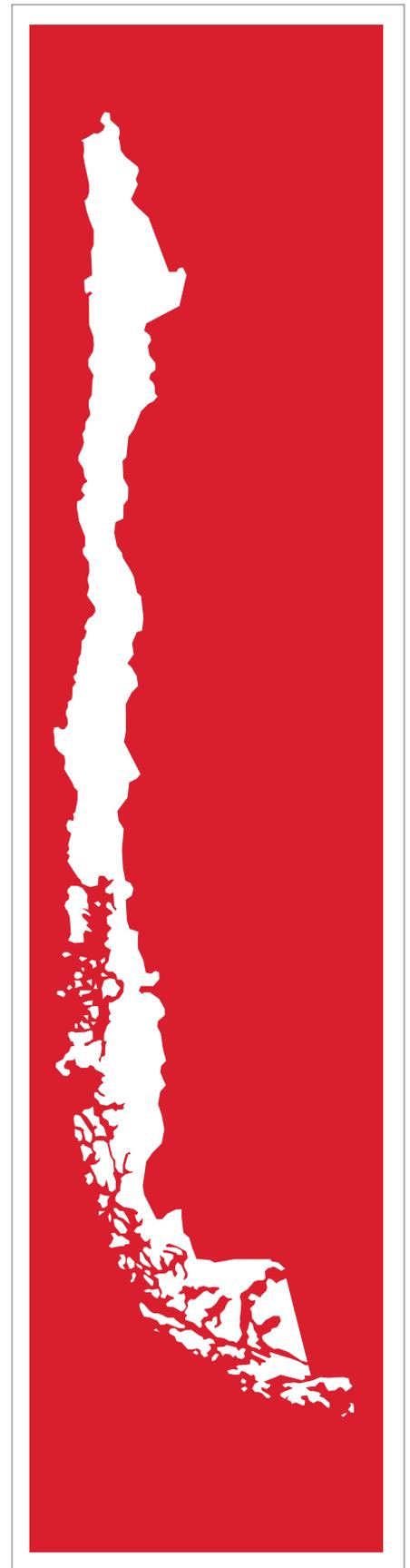
## C. START-UP CHILE 54

Start-Up Chile addresses the innovation and entrepreneurial aspect of a venture capital ecosystem. Founded in August 2010, it is part of CORFO, the Chilean economic development agency. CORFO was established in 1939 to help reconstruct Chile after a disastrous earthquake and had since evolved its focus to include entrepreneurship, innovation, technology transfer and scientific and technical education. Its activities in support of innovation were funded by a special tax on copper mining.

Before Start-Up Chile was developed, a CORFO team led by Nicolas Sorensen spent over a year gathering market information. They found that the private equity landscape had two distinct segments: early stage/seed companies that qualified from grants from CORFO and a well-developed growth equity sector. But there was no institutionalized way for small innovative start-ups to move from their CORFO grants to later stage funding; these companies went into "Death Valley," said one expert. Venture capital was seen as a bridge between entrepreneurs and the financing industry.

As in many other situations, the team examined the successful examples of such programs around the world and concluded that the industry needed entrepreneurship to attract venture capitalists. Given Chile's small size, the companies would need to be able to operate across boundaries and to appeal to global venture capital firms. If small Chilean companies could succeed in an international setting, the group reasoned, the profile of the entire country would rise.

Start-Up Chile was part of CORFO's effort to provide deal flow in which venture capitalists, whether domestic or international, would want to invest. The program offered to entrepreneurs (either Chilean or foreign) \$40,000 of seed capital, of which the entrepreneurs had to match at least 10%; a temporary year-long visa, social security, a bank account, and work space including a desk and wireless Internet. The entrepreneur had to agree to come to Chile for at least six months to work on a business that was less than two years old. In addition, the entrepreneur had to participate in a number of presentations, conferences, or seminars held at schools and universities to talk about entrepreneurship and innovation.



At first, the concept of giving money to foreigners who did not pay taxes was controversial. The amount, however, was modest and the maximum number of entrepreneurs was 100. The selection process was handled by YouNoodle, a California-based start-up that assembled a group of Silicon Valley experts to assess the submissions based on the quality of the founding team, the project's merits, and the likely impact on Chile's entrepreneurial environment. The final decision was made by InnovaChile, the division of CORFO that focused on innovation. Projects were encouraged to be as varied as possible.

The first program had 24 participants. The program required some revisions: the reimbursement process was cumbersome; the original space quickly became too small; and some participants complained loudly and publicly when things were not to their liking. But InnovaChile and CORFO streamlined the reimbursement process and found additional space, and the program received great publicity.

Much of the program proved very successful. One aspect of it, a series of Meet-ups to encourage networking among the entrepreneurs, quickly grew from 20 at the first to 60 three times a week in locations across the country. Noted a Chilean expatriate who was part of the first group at Start-Up Chile, "Failure brings negative consequences in Chile, both legally and socially. Hence, entrepreneurs are afraid to share and they end up with no feedback on what they are doing. Meet-ups are an excellent way to break that barrier."<sup>55</sup> Two Start-Up Chile alumni had started organizing Meet-ups for social enterprise entrepreneurs.

## RESULTS

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By early 2012, Start-Up Chile entrepreneurs had given more than 300 talks. More than 100 meet-ups had been held, in addition to meetings with corporations including EM, Masisa, Banco de Chile, and Metro S.A. At least 2,100 people, most of whom were Chilean, had attended the meet-ups, and more than 50 Chilean entrepreneurs had been mentored by Start-Up Chile participants. Close to \$8 million had been raised by the program's entrepreneurs from investors in the Americas, Argentina, and Mexico.

Other benefits were difficult to measure. Because the entrepreneurs had six months of runway, they could postpone raising capital or depleting their savings. Their projects were therefore at a more advance stage when they went to raise money, which often allowed them to do so at a higher valuation. The program also had generated substantial positive "buzz" about Chile and its willingness to take risks around innovative companies. Starting in 2012, the program had expanded to 300 entrepreneurs per year, from the initial idea of 100.

# 5.

## GUIDELINES FOR CREATING A VENTURE CAPITAL ECOSYSTEM

The prior discussion has ranged around the globe as we sought examples of the best and worst practices for creating a venture capital ecosystem. In this section, we put forth a few specific guidelines. These cannot, of course, be taken as One Size Fits All—we have already seen the disaster that occurred when Malaysia tried to imitate Singapore’s Biopolis. Countries differ profoundly in terms of education systems, degree of risk tolerance, regulatory structure, and even their societal attitudes toward entrepreneurship. Table 2 shows that the countries of LAC have made varying amount of progress toward creating a venture capital ecosystem. It is to be hoped that not only will each country think hard about its own needs, but that the nations that have made more progress will assist those that are just setting out on this long project.

**TABLE 2**  
STATUS OF VC ECOSYSTEM IN LAC COUNTRIES

<b>MOST DEVELOPED VC ECOSYSTEMS</b> BRAZIL, CHILE, COLOMBIA, MEXICO	<b>MOVING TOWARD CONDUCIVE BUSINESS AND/OR REGULATORY ENVIRONMENT</b> PERU, URUGUAY, ARGENTINA, PANAMA, COSTA RICA	<b>CURRENTLY DO NOT HAVE CONDUCIVE BUSINESS AND/OR REGULATORY ENVIRONMENT</b> BARBADOS, BAHAMAS, JAMAICA, SURINAME, TRINIDAD & TOBAGO, BOLIVIA, PARAGUAY, BELIZE, DOMINICAN REPUBLIC, EL SALVADOR, GUATEMALA, HONDURAS, HAITI, NICARAGUA, ECUADOR, GUYANA, VENEZUELA
Most promising VC ecosystems Acceptable legal, tax and regulatory frameworks in place Fund managers with track records Local capital markets and strategic exits possible Attractive SMEs and entrepreneurship culture Still room for improvement PE is most developed in Brazil, but early stage VC, seed and angel investing needs to be developed further	Entrepreneurship is flourishing Angel groups starting Incubators are comercializing Entrepreneurs starting to understand VC Corporate governance and accouting standards receiving attention Few capable local VC fund managers Funds with track record in PE only Some government actions are not investor friendly VC laws need to be improved or put in place (e.g. Argentina, Mexico) Tax treatment of VC investments needs improvement Exit options are limited Pension funds do not invest or are not permitted to invest in VC No organized government support to VC Minority shareholder protection rights are ambiguous	Early stages corporate governance awareness Angel groups starting Scarcity of capable local VC fund managers Business environment at times challenging No local laws for VC investing, so only off-shore funds are possible DFIs and foreing PE regional funds are the main investors in VC/PE Pension funds not investing in VC Difficult to generate adequate deal flow due to size of markets Exit options are limited Government does not provide organized support to VC industry Minority shareholder protection rights are ambiguous Low leves of entrepreneurship Few incubators Quality of accounting standards is ambiguous VC and seed investing not well-known

SOURCE MIF/FOMIN

Below are a set of guidelines for governments contemplating a program to create a venture capital ecosystem.

**1** *Where are you?* Without knowing the country's needs, it is impossible to create a program that will meet them. Thus, a government intent upon creating a venture capital ecosystem needs to meet with all the players—banks, regulators, pension funds, entrepreneurs, university rectors, export groups, individuals running incubators, tax authorities and the like—to explore their concerns and goals for such a project. Important starting points are provided by the World Bank's Doing Business report (Appendix 1) and the Latin American Venture Capital Association's Scorecard (Appendix 2). Comparing one's country's standing in those rankings with the global leaders provides an objective assessment of shortcomings, clear direction regarding priorities, and a list of better-performing countries that may be consulted for guidance.

**2** *Look for help.* Having decided on the areas on which to focus, policy-makers should reach out to experts for help. Not only are there success stories among other countries, but supra-national groups like the MIF have advisors and publications that can help direct policy. Conferences and trade exchanges can also build networks and increase a group's experience with the nuances of the venture capital industry.

**3** *Staff the effort carefully.* Find individuals with experience in the venture capital industry and an understanding of the incentives and thought processes of the players.

**4** *Set the table.* As we noted earlier, investing in high-growth companies appears to be far more interesting than reforming tax policy, pension regulation, bankruptcy law, and stock exchange listing regulations. Policy makers are strongly urged, however, to avoid the former unless the program is carefully designed and, almost always, structured through intermediaries.

**a** *Gather information.* A relatively low-cost and high-profile way for the program to signal its commitment to developing a venture capital ecosystem is to establish a venture capital association. Taking the data gathered and reported by LAVCA or the U.S.-based National Venture Capital Alliance (NVCA) as a model, the group can act as a clearing house for information on the local venture capital environment as it develops. Creating a website provides a platform that can link all the players.

**b** *Don't forget the managers:* Encouraging the university system to provide training in management and business, as well as engineering and computer science, will develop a population with the necessary management skills as well as those in innovation. Many private equity practitioners throughout the developing world echo Michael Porter's comment that emerging markets aren't under-developed but under-managed.

**c** *Make it easy:* To the extent possible, keep local regulations and fund structures in step with international norms. In addition, simplify the process for people, goods, and ideas to enter the country. VC money and people go where it's easy; a difficult entry process increases the rewards necessary to offset the inconvenience.

**5** *Right-size the program.* A program that is too small risks becoming irrelevant unless it is very cleverly managed. An excessively large program risks crowding out private investment, as seen in the example of the U.S. clean tech program. By relying on market messages and matching funds, as Brazil's INOVAR did in its Seed Fund program, an effective program can be designed.

**6 Listen to the market.** The matching funds programs of Israel's Yozma and the New Zealand Venture Investment Fund are good examples of increasing the potential rewards to private investors who invest in promising companies. In each case, the program provided a match of more than 100% for the funds raised and either took only its returned capital and a small rate of interest or allowed investors to buy out the government position for a small interest rate. Such programs increase the returns available to the managers and investors yet require the private groups to place some funds at risk and focus on creating gains. Programs that cushion losses through loss-guarantee programs reduce the managers' incentives to find and manage good companies.

**7 Measure the right things.** A strong tension exists between the next guideline (Be patient) with measurement, as many metrics are short-term in nature and can lead to the abandonment of a program before it has a chance to deliver results. An excessive focus on inputs (amount of money invested) can derail a program by discounting the quality of the output. Incomplete measurements (reporting the number of companies founded) similarly fails to discern whether the company is sustainable—did it raise money from outside groups? How did its products fare? Maddeningly, there is no one right measure. We therefore recommend using a number of different metrics and tracking the change over time more than a particular absolute level. This is, however, a difficult feature of a program and requires careful thought.

**8 Be patient.** The lifetime of a standard venture capital fund is 10 years. Unfortunately, the typical electoral cycle is four or five years. This mismatch can lead to two unfortunate situations: the incumbent administration cuts funding for a promising venture capital program that has yet to show results, or an incoming administration cuts the program to allocate resources toward its own priorities. Such stop-and-start progress is extremely destructive, as companies and VC firms cannot rely on a program's funding. Short of partnering with a supra-national group, ensuring the continuity of a program can be very difficult.

**9 Attend to the details.** Without contradicting #8, above, it is nonetheless important that policy-makers note the progress of their programs. A program aimed at boosting a particular sector of the economy may succeed by attracting private investment, which is a signal that the program should target a different sector. A program may not be producing the desired results, which calls for a reassessment of the goals and approaches being used. The national venture capital group may be able to take over a program that introduces college students to entrepreneurship. Such reassessment of the program's focus and approach allows it to allocate its funds most effectively. Over time, as with Yozma, a program may wish to dissolve itself in recognition that a venture capital ecosystem has been established. Alternatively, it may shift its focus to running a fund-of-funds. In any event, thoughtful reassessment of the progress toward its goals is essential.

**10 Stay in touch.** Ongoing communication with all players in the local and global ecosystems ensures that the policy makers and their programs keep abreast of changes in the market. Attending conferences is important not just in the planning stages but over time to maintain and develop networks. VC is global and it is important to be aware of the changes occurring on the global stage.

The evolution of VC ecosystems is mirrored in the processes of the firms that are on the ground there. In Appendices 3 and 4, we supply the accounts of two fund managers in LAC, Prosperitas Partners in Uruguay and CRP in Brazil, of the lessons they learned over their years of investing in rapidly changing environments.

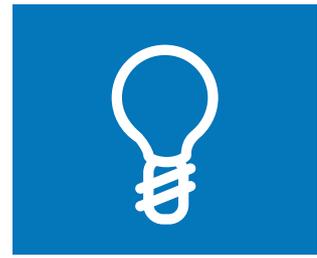
# FINAL THOUGHTS

Creating good policy for encouraging innovation, entrepreneurship, and a VC ecosystem is not impossible. A number of countries have made remarkable progress. But government needs to restrain its natural desire to intervene directly, just as venture capitalists are unlikely to make particularly skilled policy makers.

Government has an important role to play, though, as set out in the preceding pages. Good policy sets the stage for the venture capital ecosystem. It creates the incentives that make individuals willing to take the risk of investing in funds as limited partners, raising and managing funds as general partners, or starting companies as entrepreneurs. It ensures that the rules are defined, explained, and followed.

In the best cases, government provides support and assistance without running the show. Matching funds are an important example in which government rewards desired behavior without dictating it. Reflecting on progress made and revising successful programs to better meet the needs at hand are also critical roles that government plays.

Creating a best practice policy to encourage venture capital is not easy. It is not “cut and paste” from another country. Each of our case studies addressed their challenges in a way that was suited to their own situation. There is no one-size-fits-all solution. But with care, thought, attention, and patience, it can be accomplished.



# GLOSSARY

The private equity industry has an arcane vocabulary that can be baffling to outsiders. This glossary attempts to define the most commonly used phrases.

## ADVISORY BOARD

A set of limited partners or outsiders who advise a private equity organization. The board may, for instance, provide guidance on overall fund strategy or ways to value privately held firms at the end of each fiscal year.

## AGENCY PROBLEM

A conflict between managers and investors, or more generally, an instance where an agent does not intrinsically desire to follow the wishes of the principal that hired him. Also known as a conflict of interest.

## ANGEL

A wealthy individual who invests in entrepreneurial firms. Although angels perform many of the same functions as venture capitalists, they invest their own capital rather than that of institutional and other individual investors.

## ASSET ALLOCATION

The process through which institutional or individual investors set targets for how their investment portfolios should be divided across the different asset classes.

## ASSET CLASS

One of a number of investment categories—such as bonds, real estate, and private equity—that institutional and individual investors consider when making asset allocations.

## ASYMMETRIC INFORMATION PROBLEM

A problem that arises when, because of his day-to-day involvement with the firm, an entrepreneur knows more about his company's prospects than investors, suppliers, or strategic partners.

## BENCHMARKS

Metrics for the performance of a fund or a company that compare it to other similar funds or operations.

## BUYOUT

See Leveraged buyout.

## CAPITAL UNDER MANAGEMENT

See Committed capital.

## CARRIED INTEREST

The substantial share, often around 20%, of profits that are allocated to the general partners of a private equity partnership.

## CERTIFICATION

The "stamp of approval" that a reputable private equity investor or other financial intermediary can provide to a company or individual.

## CLOSED-END FUND

A publicly traded mutual fund whose shares must be sold to other investors (rather than redeemed from the issuing firm, as is the case with open-end mutual funds). Many early venture capital funds were structured in this manner.

## CLOSING

The signing of the contract by an investor or group of investors that binds them to supply a set amount of capital to a private equity fund. Often a fraction of that capital is provided at the time of the closing. A single fund may have multiple closings.

### **CO-INVESTMENT**

Either (a) the syndication of a private equity financing round (see syndication), or (b) an investment by an individual general or limited partner alongside a private equity fund in a financing round.

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### **COMMITTED CAPITAL**

Pledges of capital to a private equity fund. Typically, this money is not received all at once, but rather taken down over three to five years starting in the year the fund is formed.

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### **COMMON STOCK**

The equity typically held by management and founders. Typically, at the time of an initial public offering, all equity is converted into common stock.

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### **CONVERTIBLE EQUITY OR DEBT**

A security that under certain conditions can be converted into another security (often into common stock). The convertible shares often have special rights that the common stock does not have.

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### **CORPORATE VENTURE CAPITAL**

An initiative by a corporation to invest either in young firms outside the corporation or in business concepts originating within the corporation. These are often organized as corporate subsidiaries, not as limited partnerships.

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### **CUMULATIVE REDEEMABLE PREFERRED STOCK**

See redeemable preferred stock.

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### **DIRECT INVESTMENT**

An investment by a limited partner or a fund of funds into an entrepreneurial or restructuring firm.

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### **DISBURSEMENT**

An investment by a private equity fund into a company.

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### **DISTRIBUTION**

The transfer of shares in a (typically publicly traded) portfolio firm or cash from a private equity fund to each limited partner and (frequently) each general partner.

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### **DRAW DOWN**

See Take down.

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### **DUE DILIGENCE**

The review of a business plan and assessment of a management team prior to a private equity investment.

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### **ENDOWMENT**

The long-term pool of financial assets held by many universities, hospitals, foundations, and other nonprofit institutions.

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### **EXPANSION CAPITAL**

See Growth capital.

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### **FINANCING ROUND**

The provision of capital by a private equity group to a firm. Since venture capital organizations generally provide capital in stages, a typical venture-backed firm will receive several financing rounds over a series of years.

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### **FIRST CLOSING**

The initial closing of a fund.

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### **FIRST FUND**

An initial fund raised by a private equity organization; also known as a first-time fund.

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### **FOLLOW-ON FUND**

A fund that is subsequent to a private equity organization's first fund.

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### **FUND**

A pool of capital raised periodically by a private equity organization. Usually in the form of limited partnerships, private equity funds typically have a ten-year life, though extensions of several years are often possible.

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### **FUND OF FUNDS**

A fund that invests primarily in other private equity funds rather than operating firms, frequently organized by an investment adviser or investment bank.

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### **GATEKEEPER**

See Investment advisor.

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### **GENERAL PARTNER (GP)**

A partner in a limited partnership is responsible for the day-to-day operations of the fund. In the case of a private equity fund, the venture capitalists either are general partners or own the corporation that serves as the general partner. The general partners assume all liability for the fund's debts.

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### **GRANDSTANDING PROBLEM**

The strategy, sometimes employed by young private equity organizations, of rushing young firms to the public marketplace in order to demonstrate a successful track record, even if the companies are not ready to go public.

---

### **GROWTH CAPITAL**

The sale of equity in a (typically) privately held operating company, frequently one that is profitable, to raise funds to increase production capacity, supply working capital, or further develop the product. Both venture capital funds and mid-market buyout funds do growth capital investing.

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### **HERDING PROBLEM**

A situation in which investors, particularly institutions, make investments that are more similar to one another than is desirable.

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### **INITIAL PUBLIC OFFERING (IPO)**

The sale of shares to public investors of a firm that has not hitherto been traded on a public stock exchange. An investment bank typically underwrites these offerings.

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### **INTERNAL RATE OF RETURN (IRR)**

The annualized effective compounded return rate that can be earned on the invested capital; the investment's yield. For both venture capital and buyout firms, the longer the money is tied up in the investment, the higher the multiple of the original investment must be returned to have an adequate IRR.

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### **INVESTMENT ADVISER**

A financial intermediary who assists investors, particularly institutions, with investments in private equity and other financial assets. Advisers assess potential new venture funds for their clients and monitor the progress of existing investments. In some cases, they pool their investors' capital in funds of funds.

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### **INVESTMENT BANK**

A financial intermediary that, among other services, may underwrite securities offerings, facilitate mergers and acquisitions, and trade for its own account.

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### **INVESTMENT COMMITTEE**

A group, typically consisting of general partners of a private equity fund (but sometimes including outside experts and, in the case of some emerging markets, limited partners), that reviews and approves potential and/or existing investments.

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### **LEVERAGED BUYOUT (LBO)**

The acquisition of a firm or business unit, typically in a mature industry, with a considerable amount of debt. The debt is then repaid according to a strict schedule that absorbs most of the firm's cash flow.

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### **LEVERAGED BUYOUT FUND**

A fund, typically organized in a similar manner to a venture capital fund, specializing in leveraged buyout investments. Some of these funds also make venture capital investments.

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### **LEVERAGED RECAPITALIZATION**

A transaction in which the management team (rather than new investors as in the case of an LBO) borrows money to buy out the interests of other investors. As in an LBO, the debt is then repaid.

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### **LIMITED PARTNER (LP)**

An investor in a limited partnership. Limited partners can monitor the partnership's progress but cannot become involved in its day-to-day management if they are to retain limited liability.

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### **LIMITED PARTNERSHIP**

An organizational form that entails a finitely lived contractual arrangement between limited and general partners, governed by a partnership agreement.

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### **LIQUIDATION**

The process of selling an investment and achieving liquidity for a fund's investors. Liquidation events can be either positive and generate profits, or negative and create losses.

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### **LIQUIDATION PREFERENCE PROVISION**

In a preferred stock agreement, a provision that insures preference over common stock with respect to any dividends or payments in association with the liquidation of the firm.

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### **LOCK UP**

A provision in the underwriting agreement between an investment bank and existing shareholders that prohibits corporate insiders and private equity investors from selling at the time of the offering.

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### **MANAGEMENT FEE**

The fee, typically a percentage of committed capital or net asset value, that is paid by a private equity fund to the general partners to cover salaries and expenses.

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### **MANAGING GENERAL PARTNER**

The general partner (or partners) who is ultimately responsible for the management of the fund.

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### **MEZZANINE**

Either (a) a private equity financing round shortly before an initial public offering, or (b) an investment that employs subordinated debt that has fewer privileges than bank debt but more than equity and often has attached warrants.

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### **MID-MARKET**

Companies somewhere between "small" and "large," variously defined in terms of ownership (most often, family-owned), employees, revenues (e.g., between \$200 million and \$600 million), enterprise value, and equity investment (e.g., between \$25 million and \$200 million).

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### **MILESTONE PAYMENTS**

In a licensing agreement, the payments made by the licensee to the licensor at specified times in the future or else when certain technological or business objectives have been achieved. Some venture capital investments may also involve payments tied to the achievement of milestones upon which all parties (investors and entrepreneurs) have agreed.

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### **MINORITY POSITION**

A situation in which an investor purchases less than majority control of a company. Frequently this occurs in venture capital and in growth or expansion capital investments; less frequently with buyouts.

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### **OPTION**

The right, but not the obligation, to buy or sell a security at a set price (or range of prices) in a given period.

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### **PARTICIPATING PREFERRED STOCK**

Convertible stock where, under certain conditions, the holder receives both the return of his original investment and a share of the company's equity.

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### **PARTICIPATION**

The quality of having participating preferred stock.

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### **PARTNERSHIP AGREEMENT**

The contract that explicitly specifies the compensation and conditions that govern the relationship between the investors (limited partners) and the venture capitalists (general partners) during a private equity fund's life. Occasionally used to refer to the separate agreement between the general partners regarding the internal operations of the fund (e.g., the division of the carried interest).

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### **PORTFOLIO MANAGEMENT**

The process of ensuring that the risk in a portfolio of investments is balanced along a variety of dimensions, which can include geography, stage, sector, and/or partner time requirements.

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### **POST-MONEY VALUATION**

The product of the price paid per share in a financing round and the shares outstanding after the financing round.

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### **PREFERRED RETURN**

A provision in limited partnership agreements that insures that the limited partners receive not only their capital back, but also a contractually stipulated rate of return on their funds before the general partners receive any carried interest.

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### **PREFERRED STOCK**

Stock that has preference over common stock with respect to any dividends or payments in association with the liquidation of the firm. Preferred stockholders may also have additional rights, such as the ability to block mergers or displace management.

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### **PRE-MONEY VALUATION**

The product of the price paid per share in a financing round and the shares outstanding before the financing round.

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### **PRIMARY INVESTMENT**

An investment by a limited partner or a fund of funds into a private equity partnership that is raising capital from investors.

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### **PRIVATE EQUITY**

Organizations devoted to venture capital, leveraged buyout, consolidation, mezzanine, and distressed debt investments, as well as a variety of hybrids such as venture leasing and venture factoring.

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## **PUBLIC VENTURE CAPITAL**

Venture capital funds organized by government bodies, or else programs to make venture-like financings with public funds. Examples include the Small Business Investment Company and Small Business Innovation Research programs.

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## **REDEEMABLE PREFERRED STOCK**

Preferred stock where the holders have no right to convert the security into common equity. The return to the investor, like that of a bond, consists of a series of dividend payments and the return of the face value of the share, which is paid out at the contractually specified time when the company must redeem the shares.

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## **REGISTRATION RIGHT PROVISION**

In a preferred stock agreement, provisions that allow the private equity investors to force the company to go public, or to sell their shares as part of a public offering that the firm is undertaking.

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## **RESTRICTED STOCK**

Shares that cannot be sold under U.S. Securities and Exchange Commission regulations or that can only be sold in limited amounts.

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## **RUN RATE**

A company's results if the performance of the current period were to be extrapolated to a full year. This can be a useful approach in fast-growing companies; it can be misleading if the company is distinctly seasonal and the base period corresponds to a seasonal peak.

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## **SECONDARY BUYOUT**

The purchase of a company in one private equity firm's portfolio by another private equity firm.

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## **SECONDARY INVESTMENT**

The purchase by a limited partner or a fund of funds of an existing limited partnership holding from another limited partner.

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## **SPECIAL LIMITED PARTNER**

A limited partner who receives part of the carried interest from the fund. In many cases, the first investors in a new fund are given special limited partner status

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## **STAGING**

The provision of capital to entrepreneurs in multiple installments, with each financing conditional on meeting particular business targets. This provision helps ensure that the money is not squandered on unprofitable prospects. Also known as a "tranching" investment.

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## **STRAIGHT PREFERRED STOCK**

See Redeemable preferred stock.

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## **SUPER MAJORITY VOTING PROVISION**

In a preferred stock agreement, a provision that requires that more than a majority of the preferred stock holders approves a given decision.

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## **SYNDICATION**

The joint purchase of shares by two or more private equity organizations or the joint underwriting of an offering by two or more investment banks.

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## **TAKE DOWN**

The transfer of some or all of the committed capital from the limited partners to a private equity fund.

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### **TAKEDOWN SCHEDULE**

The contractual language that describes how and when a private equity fund can (or must) receive the committed capital from its limited partners. In venture leasing, the period after the lease begins when the lessee can draw down funds for the preapproval equipment to be purchased.

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### **TERM SHEET**

A preliminary outline of the structure of a private equity partnership or stock purchase agreement, frequently agreed to by the key parties before the formal contractual language is negotiated.

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### **TERTIARY BUYOUT**

The sale of a private-equity-owned company to another private equity firm when the selling firm had purchased the company from a previous private equity owner.

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### **TRADE SALE**

A European term for the exiting of an investment by a private equity group by selling it to a corporation. Usually called a merger or an acquisition in the United States.

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### **TRANCHED INVESTMENT**

An investment where money is released contingent upon the company's achievement of specific milestones. See Staging.

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### **UNCERTAINTY PROBLEM**

The array of potential outcomes for a company or project. The wider the dispersion of potential outcomes, the greater the uncertainty.

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### **VENTURE CAPITAL (VC)**

Independently managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high growth companies. Many venture capital funds, however, occasionally make other types of private equity investments. Outside of the United States, this phrase is often used as a synonym for private equity.

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### **VENTURE CAPITALIST**

A general partner or associate at a private equity organization.

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### **VENTURE RETURNS**

The general range of returns expected from venture capital firms, usually between 15% and 20%. This expected return may have little correlation to returns actually generated.

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### **VESTING**

A provision in employment agreements that restricts employees from exercising all or some of their stock options immediately. These agreements typically include a schedule specifying the percent of shares that the employee is allowed to exercise over time, known as a vesting schedule.

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### **VINTAGE YEAR**

The group of funds whose first closing was in a certain year.

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### **VOLATILITY**

The standard deviation of returns around the mean, or the degree to which portfolio performance may vary over time.

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# APPENDIX



# APPENDIX 1

## WORLD BANK EASE OF DOING BUSINESS RANKINGS FOR LAC

Economy	World Rank	Regional Rank	Starting a Business	Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
Chile	37	1	4	17	12	5	7	5	1	5	3	15
Puerto Rico (U.S.)	41	2	1	31	10	20	1	3	14	19	14	2
Peru	43	3	9	18	21	1	4	2	9	8	18	17
Colombia	45	4	10	8	30	4	10	1	13	17	26	1
Mexico	48	5	5	10	28	25	6	12	15	9	7	3
St. Lucia	53	6	8	3	2	16	20	5	2	24	28	9
Panama	61	7	3	16	3	12	7	14	31	1	22	19
Antigua and Barbuda	63	8	17	7	5	19	20	5	25	25	5	12
Dominica	68	9	7	6	17	17	13	5	7	18	30	16
Trinidad and Tobago	69	10	15	21	1	32	4	4	11	12	30	22
St. Vincent and the Grenadines	75	11	11	1	7	26	26	5	6	3	12	31
Bahamas, The	77	12	16	14	13	33	13	21	5	7	21	7
Barbados	88	13	14	12	22	28	13	27	17	2	16	4
Uruguay	89	14	6	32	6	29	10	18	23	22	15	8
Jamaica	90	15	2	11	25	11	20	14	30	23	24	6
Guatemala	93	16	30	20	9	2	1	26	19	26	10	18
St. Kitts and Nevis	96	17	13	4	4	30	26	5	21	10	20	31

Economy	World Rank	Regional Rank	Starting a Business	Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
Grenada	100	18	12	2	18	27	20	5	9	11	27	31
Paraguay	103	19	19	15	8	7	13	13	24	32	17	26
Belize	105	20	28	5	15	23	26	23	3	21	29	5
Costa Rica	110	21	21	26	14	3	13	27	20	6	23	20
El Salvador	113	22	24	29	29	6	7	27	27	13	4	13
Guyana	114	23	18	9	32	15	33	14	16	15	6	24
Dominican Republic	116	24	23	23	24	14	13	18	12	4	9	27
Nicaragua	119	25	22	30	27	18	20	18	29	14	2	11
Argentina	124	26	26	33	20	22	10	21	26	30	1	14
Honduras	125	27	27	13	23	9	1	27	22	16	32	21
Brazil	130	28	20	27	16	13	20	14	28	27	19	25
Ecuador	139	29	29	22	31	10	13	24	8	29	12	23
Bolivia	155	30	31	25	26	24	26	24	32	28	25	10
Suriname	164	31	32	19	11	31	30	33	4	20	33	28
Haiti	174	32	33	28	19	21	30	27	18	31	11	29
Venezuela, RB	180	33	25	24	33	8	30	32	33	33	8	30

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**SOURCE** World Bank and IFC, Doing Business, 2012, <http://www.doingbusiness.org/rankings>, accessed October 23, 2012.

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# APPENDIX 2

## LAVCA SCORECARD, 2012 (100 IS HIGHEST)

	Argentina	Brazil	Chile	Colombia	Costa Rica	Republic Dominican	El Salvador	Mexico	Panama	Peru	Trinidad & Tobago	Uruguay	Israel	Spain	Taiwan	UK
Overall score	42	72	75	60	56	39	39	65	49	49	57	57	78	76	63	96
Laws on VC/PE fund formation and operation	1	4	3	3	2	2	0	2	2	2	2	2	4	3	4	4
Tax treatment of VC/PE funds & investments	1	3	3	2	3	1	2	3	2	1	3	3	2	4	3	4
Protection of minority shareholder rights	2	3	3	3	1	2	1	3	2	1	2	2	4	3	1	4
Restrictions on institutional investors investing in VC/PE	0	3	3	3	1	1	1	3	2	2	2	2	3	3	2	4
Protection of intellectual property rights	2	2	3	2	3	1	2	2	2	2	3	2	2	3	3	4
Bankruptcy procedures/creditors' rights/partner liability	2	3	3	2	2	1	2	2	2	2	2	3	2	3	3	3
Capital markets development and feasibility of exits	2	3	3	2	2	1	2	3	2	2	2	1	3	3	3	4
Registration/reserve requirements on inward investments	1	3	3	3	3	3	3	3	3	3	4	3	3	3	3	3
Corporate governance requirements	2	3	3	3	2	3	1	3	2	3	2	2	4	3	2	4
Strength of the judicial system	2	2	3	2	3	1	1	2	2	1	2	3	3	2	2	4
Perceived corruption	1	1	3	1	3	0	1	1	1	1	1	3	3	3	2	3
Quality of local accounting/use of international standards	4	4	3	2	4	3	3	3	2	4	3	3	4	4	2	4
Entrepreneurship	3	3	3	2	2	1	2	2	1	2	2	2	3	2	4	4

**SOURCE** Latin American Venture Capital Association, 2012 LAVCA Scorecard on the Private Equity and Venture Capital Environment in Latin America, May 2012, p. 4, <http://lavca.org/wp-content/uploads/2012/06/2012-LAVCA-Scorecard-FINAL.pdf>, accessed October 24, 2012

# APPENDIX 3

## REPRESENTATIVE LESSONS LEARNED BY GENERAL PARTNERS OF LATIN AMERICAN AND CARIBBEAN VENTURE CAPITAL FUNDS

The fund managers in emerging markets face a difficult task. Not only must they operate within an evolving marketplace, but they are also trying to create value in young companies. Often, the management teams are unaccustomed to active minority investors, and sometimes resist their recommendations. Should the management teams fail to perform, finding replacements can be difficult and time consuming. New investment teams may find that every move is scrutinized, not just by their limited partners and management teams but also by policy-makers who want to be sure that the program succeeds.

The following two accounts were written by general partners (GPs) active in the early stage investing sector. One is based in Brazil and the other in Uruguay. Their lessons learned demonstrate the evolution of a market and the process of discovery that the firms have experienced, touching on all aspects of the venture capital cycle. In the deal origination process, teams mentioned the importance of hiring specialists to help understand the company's management, technology, and market more deeply. Others expanded their due diligence conversations to include midlevel managers, not just the senior team. To improve company performance, the teams actively invested in management education, even to the point of recruiting mentors to provide individual coaching and, possibly invest as angels. The allocation of ownership shares among the managers was another lesson: instead of sharing them evenly across the group; they should be awarded relative to the value of the individual's contribution to the company going forward. Another firm sought to develop innovative investment securities that would balance the market's state of evolution, particularly its uncertainty about classic venture capital valuation techniques, with the firm's need for adequate risk compensation. Several of the accounts detail changes in the firm's internal structure and processes in terms of communication and hiring as result of their experiences.

These accounts depict a vibrant venture capital landscape. To succeed, teams must be willing to experiment and pay careful attention to the results of their efforts, continuously revising their approach as the system around them changes.

We thank the teams who took part in this competition for their efforts and commend all of them. They represent a key part of the evolution of the venture capital ecosystem in Latin American and the Caribbean.

# A CHANGE PROCESS CASE AT COMPANHIA DE PARTICIPAÇÕES<sup>2</sup> (CRP)

## INTRODUCTION

After 31 years, CRP has acquired a unique expertise in the Brazilian market. With nine funds under management, 69 investments and 41 divestments since 1981, CRP is the leader in terms of number of investments in the Brazilian Venture Capital and Private Equity industry. CRP has always taken a minority investment approach, based on a strong relationship with the entrepreneur/business owner. Year over year, CRP evolved its management process. Most of these innovations came out from lessons learned, as demonstrated in the four cases about experiences from our RSTec fund that will be highlighted in this article. At the end of the article, we will show how things changed internally in CRP in response to these lessons.

In 1999, CRP launched its third fund, RSTec with committed capital of US\$4.4 million. This was a venture capital fund focused on startups, early stage and small innovative companies, in terms of both product innovation and management process innovation. The Fund's investments were restricted to companies located in Rio Grande do Sul State, where CRP headquarters are located. The RSTec Fund invested in 15 companies (10 divested – 7 buybacks and 3 strategic sales; 4 write-offs; and 1 currently being divested). The portfolio was composed of 40% startup companies (no revenues), 47% early stage companies (revenues but no profits) and 13% small companies.

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2. CRP Companhia de Participações – [www.crp.com.br](http://www.crp.com.br)  
Address Av. Soledade, 550/1001 – Porto Alegre/RS – Brazil – +55 51 32110777

# RSTEC: LESSONS LEARNED

## A SOFTWARE DEVELOPER

*The investment was made in 2003. At that time, another venture capital firm already had a minority interest in the company. After three years of monitoring, CRP and the other shareholders wrote off the investment.*

The Company was founded in 2003 to develop unique software tools for developing new software/systems programs and serving as a repository of knowledge about the data model, business rules, and systems frameworks. During the due diligence process, the product's unique benefits (productivity and usability, among others) were verified by technical experts.

Thus, we saw an opportunity to invest in a company with an innovative product that filled a pronounced hole in the market and where its technology allowed full integration with other productivity tools then available in the market. In addition, the Company had a structured and experienced team that had led the project since the beginning. Moreover, the CEO's international experience in the sector would be a valuable asset during the Company's international expansion, one of the major goals of the investment thesis.

At the time of the investment, CRP was already monitoring the Company closely. The major efforts focused on mitigating the execution risk associated with the Company's action plan, which lacked focus and consistency. The business plan was oriented to the development of the international market, where productivity tools for software/systems programming were widely accepted and demanded. This strategy would also accelerate the likelihood of a strategic sale in a relatively short period.

The facts, however, presented a different picture. Perceiving the difficulty of exporting to the international market, CRP tried, but struggled, to establish a more consistent shorter-term strategy for the Brazilian market. CRP also tried to establish a consistent commercial plan and to reduce operational expenses (structure and people) to keep financial resources at a comfortable level and maintain the business in the long run. CRP was relatively successful and the burn rate decreased drastically, which provided momentary financial stability for the Company. Unfortunately, these actions were not enough for the company to maintain the ideal capital structure in the long term. The sales performance lagged the original projections and the expenditures remained excessively high, due to:

- a** the inability of the top executives, most of whom had come from large operations, to manage a small company;
- b** the difficulty in making the product work, the need for an additional outsourcing team to do implementation, and the high level of customization and training necessary to help customers adopt it; and
- c** the customers' cultural barriers against adopting the tools. This was not anticipated in the business plan and required paradigm shifts in the minds of the users and changes in the customers' internal management processes for success.

### The major lessons learned in this investment case were:

- i)** The need to implement a more sophisticated due diligence process to understand the business deeply;
- ii)** The need to evaluate the top executives' profiles and skills to run the business; and
- iii)** The need to calculate the right amount of capital needed, in order to guarantee the Company's growth in the projected investment period

## A WEB SERVICE COMPANY

The investment was made in 2002. By 2004, CRP had already divested the position.

Some years before the Fund's investment, the Company had been founded as a distance learning website. Over the years, the Company expanded its business to the web services customization market and started developing websites and integrating databases with an exclusive focus on corporate solutions. During this strategic shift, the Company began developing applications and software programs for PDAs (Personal Digital Assistants) and smart phones, a fast-growing new global market.

During the due diligence process, the investors concluded that the technological aspects of the solution did not seem to be a critical issue for the Company's success. On the other hand, the commercial ability of the entrepreneurs/executives was critical, as this skill would reduce the risk of accessing a new market. Commercial success would increase the likelihood that the Company would generate higher revenues in the short term, normally a period of fragile cash flow for any early stage company. Also, because the market was new, there were no dominant software companies operating in the PDA market (mobile solutions). The Company had excellent opportunities to become the leader in Brazil and leadership in that market would enhance its value to potential strategic buyers interested in consolidating the sector.

The development team mastered the programming technology for producing mobile applications for PDAs. The main product, sales force applications, was very versatile and could be applied in several different sectors/industries without requiring major customization.

After its investment, CRP started helping the Company to implement the best corporate practices available. The Board of Directors was established and an external auditing company was hired. CRP also encouraged the entrepreneurs to do yearly rounds of strategic planning in order to reassess the original business plan and maintain progress towards the best growth path.

Even with all of CRP's efforts and support, the Company could not reach its goals due to the lack of an internal management process and the CEO's excessive centralization of decision-making. Additionally, misalignments amongst the entrepreneurs, in terms of dedication and commitment to the Company's project, had an adverse impact on the Company's daily operations.

The business's continuing weak performance and the lack of management controls increased the risk that CRP was assuming in terms of potential contingencies. In the face of a continued slump, CRP decided to divest because it did not believe the business would recover and it wanted to mitigate any potential contingent risk such as lingering labor issues or unpaid bills. The Fund sold its stake to one of the entrepreneurs for a symbolic value and took a negative return on the deal.

### The major lessons learned in this investment case were:

- i) The need to evaluate the top executives' profiles and skills deeply;
- ii) The need to assess the entrepreneurs' relationship to detect potential conflicts and misalignment between them; and
- iii) The need to improve the monitoring process, focusing on the investees' main projects and the way they are being managed.

## A BROADBAND INTERNET PROVIDER

The investment was made in 2000. After approximately 2 years, CRP wrote it off.

The company resulted from a joint venture between a service company that did maintenance and implementation of cable networks and a communication technology provider of products and services. The deal was syndicated by three investment groups, led by CRP.

The company provided broadband Internet access through high frequency radio technology. The goal was to supply high-speed Internet at a competitive price and with innovative technology, in a fast growing market, in which the major competitors were rapidly taking positions but lacked a competitive solution, as their services were slower and more expensive.

The Company's technological knowledge and market positioning in the Southern Region of Brazil represented a good opportunity to expand the business to the whole country and to become the major provider of broadband solutions. Due to its proprietary technology, the Company's service reached constantly higher speeds and met the growing demand for very fast Internet connections. The company's technology capabilities gave it a unique position in the Brazilian broadband market, attracting the attention of investors and potential strategic buyers and offering the Fund attractive divestment opportunities.

In the merged company, CRP and the other investors played a very important role as an element of balance between the two operations and their entrepreneurs. The two groups of entrepreneurs had different profiles, one more conservative and the other more aggressive, which created conflicts. CRP was called upon to resolve several conflicts between the managers. In addition, the Company had a "family" (nonprofessional) management approach, which created fragile processes and insufficient internal controls and communication between areas. CRP pushed the entrepreneurs to establish an organizational structure based on a professional CEO, who was not related to the controlling families. Furthermore, CRP led the discussions to change the commercial strategy from a "retail" approach to a corporate approach. This shift added value to the business.

### The major lessons learned in this investment case were

- i) The need to evaluate more profoundly the top executives profiles and skills;
- ii) The need to access the entrepreneurs' relationship level to detect potential conflicts and misalignment between them;
- iii) The need to improve the monitoring process, focusing on the main projects of the investees and their management process; and
- iv) The need to establish a controllership area to support the portfolio companies from the beginning of the investment.

## A MACHINE VISION SYSTEM SOLUTION PROVIDER

The investment was made in 1999. After nine years of active monitoring, the company was divested with a negative internal rate of return.

The company developed machine vision systems. These systems have several applications, all related to controlling processes (production, logistics, among others) that would be almost impossible to do manually. The main objective is to reach a zero failure rate in any of the processes.

Despite facing few competitors, the Company never managed to capture the available market opportunities. The market for machine vision solutions in Brazil was quite new. The few clients that were interested in the technology demanded custom systems, which were high-cost due to state-of-the-art technology requirements, and not necessarily applicable to other potential clients, which precluded economies of scale.

The Company was initially oriented towards finished products that could be commercialized in specific markets. This idea contravened the tailor-made model that was prevalent in the market. The goal was to gain scale and to increase the Company's commercial focus. The entrepreneurs had strong technical backgrounds but little experience in commercialization. CRP coached them about commercialization and eventually hired a specific team for this task. CRP also helped the entrepreneurs to stay focused on the commercial viability of the products, rather than their technological aspects.

Despite all these efforts and strategies, the market grew more slowly than projected and the product adoption rate lagged expectations, due to cultural barriers and lack of resources for new capital expenditures. Furthermore, keeping highly skilled teams was a huge challenge because of the frustration caused by slow sales growth. The Company's need for working capital was constant and high. Efforts to gain scale and reduce costs were thwarted by the clients' demand for product customization. In the end, the Fund divested its stake to the majority shareholder in a buyback deal.

### The major lessons learned in this investment case were:

- i) The need to evaluate the market size and perspectives more deeply; and
- ii) The need to improve the monitoring process, focusing on the investees' main projects and their management process.

# LESSONS LEARNED

The lessons learned made CRP rethink its investment approach and internal processes, in addition to its organizational structure. According to the limited partners, business owners, and others related to the segment, these changes were quite innovative in the context of the Brazilian Private Equity industry.

The first innovation involved having an organizational behavior psychologist produce a psychological and profile analysis of the business owners and key executives. This new process was extremely important in helping us understand the profile of the leading executives and in confirming their capabilities and alignment with the business goals. Additionally, this understanding allows the Fund to better understand the business owners and guarantee an alignment of interests with them during the investment years, which is very important for a successful divestment. The new analysis also covers other aspects of the portfolio companies such as: identifying the synergies among the team; understanding the companies' culture; attesting to the quality of the management team; and understanding the succession and the innovation processes, among others.

Another innovation in the due diligence process was our new approach of hiring specialists in management processes and business strategy as consultants to analyze the main internal processes (production, administrative, commercial and financial), the business strategy, and the major internal projects. The objective is to check the alignment of the top executives in certain areas such as i) how to run the business, ii) future projects and iii) business perspectives. This new assessment helped us better understand the business plan, along with how to act and where to focus to develop the business efficiently.

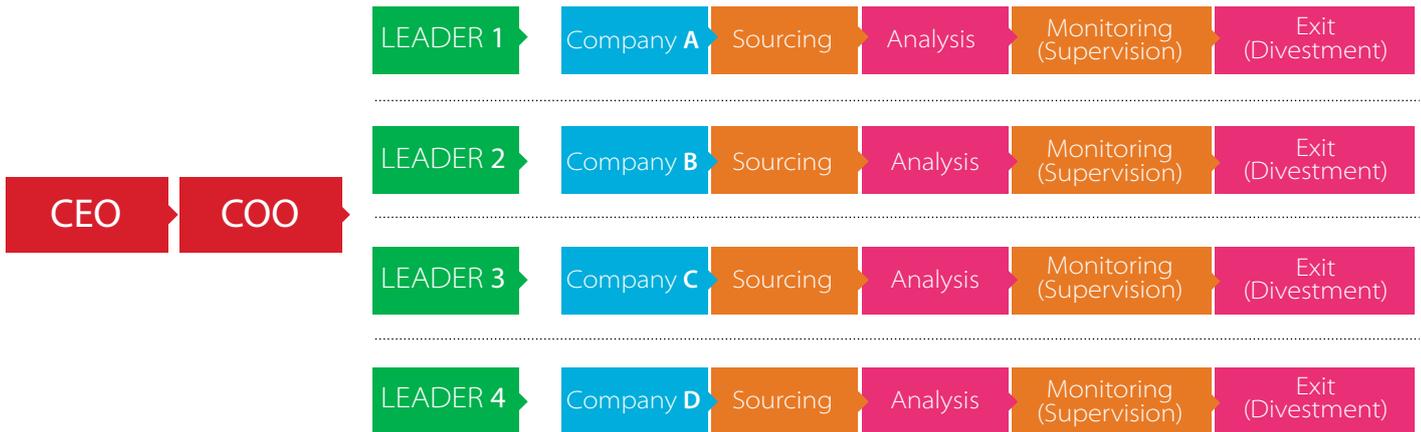
The lessons learned also improved other aspects of the due diligence process, such as the assessment of the market and the competitive environment, the evaluation of the business's internal processes and relations with the companies' stakeholders, and also helped us develop a consistent business projection to get a better picture of the companies' potential growth. CRP implemented a standard due diligence structure that considered the main issues to be analyzed in a company, including the valuation models, based on the best practices of the industry. CRP also started doing a pre due diligence analysis of the accounting, tax and legal aspects of the businesses during the appraising process.

**FIGURE 1.** Due Diligence Process

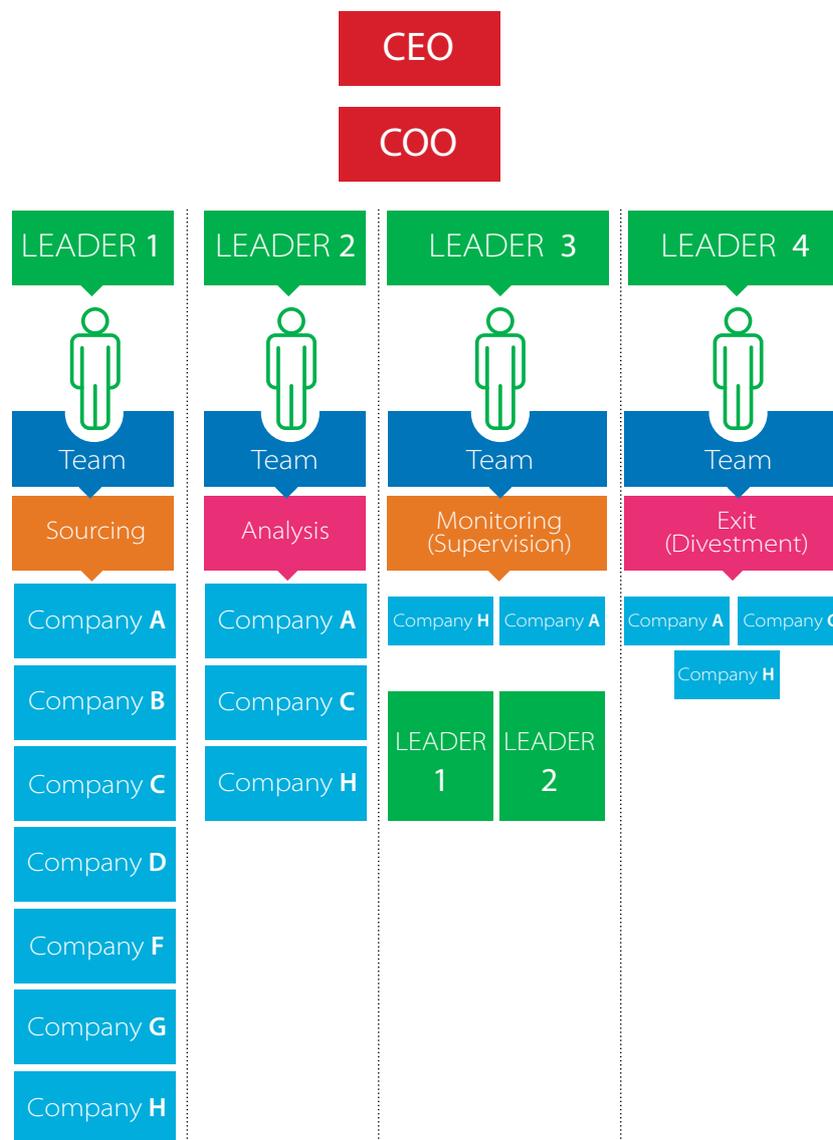


Another important change happened in CRP's internal structure: the firm moved from a model based on individuals to a model based on areas. Likewise, private equity and venture capital funds and operations were separated when CRP launched its first Private Equity Fund, CRP VII in 2010. The partners were divided by profile to manage the main areas of the investment process (prospection, due diligence, monitoring and divesting). The new management model was important to avoid problems that could arise in the investment cycle when one of the steps is more demanding than the others and also helped establish standards to give more consistency to all activities. See Figures 2a and 2b for the different structures.

**FIGURE 2A.** CRP Operational Structure 1981-2009



**FIGURE 2B.** CRP Operational Structure since 2010



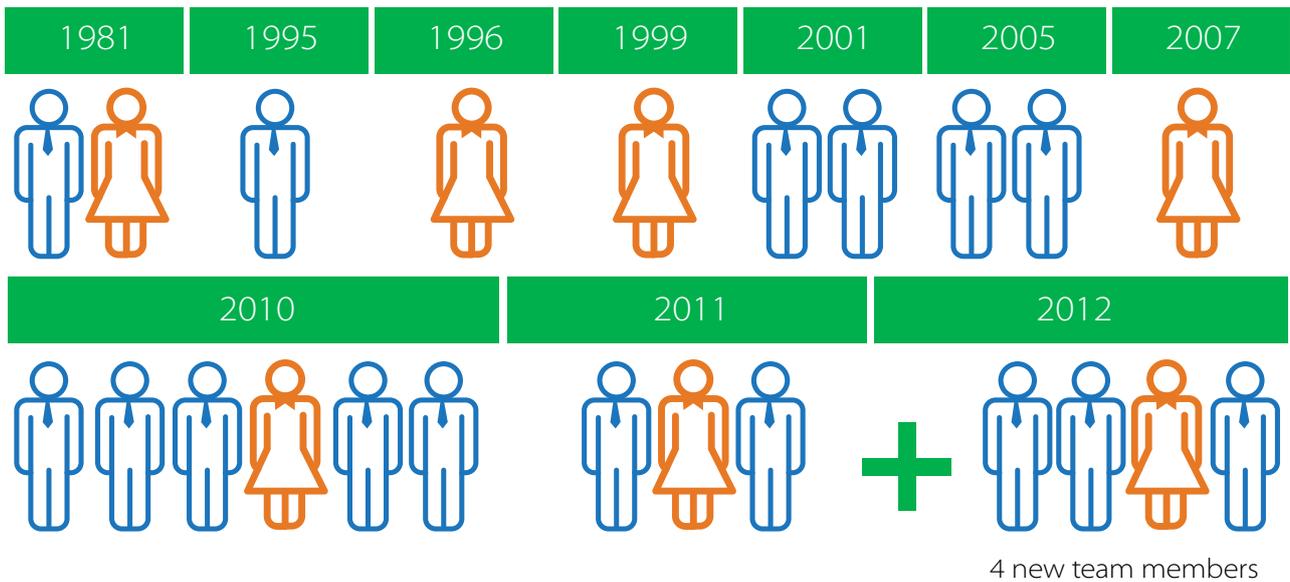
The monitoring process also changed to cover all business levels. CRP had always interacted with the investees on the strategic, governance, and shareholders levels, with great involvement in decision making. Starting in 1999, a new process was implemented to better monitor the investees at the management level. In 2006, CRP increased its efforts to follow the companies' internal processes more closely. In 2012, CRP brought the monitoring process to another level and began giving direct advice to the investees' operational areas on how to manage the fundamental projects in order to increase the success of the business plan. This new process is driven by the investees' needs as defined by the board of directors. The CRP team goes to the investees to do a diagnosis and to help them restructure those processes that are not running properly. This teamwork approach ensures the efficient execution of the main projects. CRP's controllership area also started to have more effective control over the investees' accounting and financial functions and tracked the results with specific indicators and regular meetings with the personnel in these departments.

**FIGURE 3.** Monitoring Process Evolution



Additionally, CRP improved the overall qualifications of its own team. Since 1999, when RSTec fund closed, 18 more professionals were added, reinforcing all internal areas. All areas are led by a senior partner who interacts closely with the team to make the processes flow efficiently. CRP’s back office area handles the financial and administrative issues of the funds and is also led by a partner. The entire company is managed by the CEO who was one of the founders of CRP.

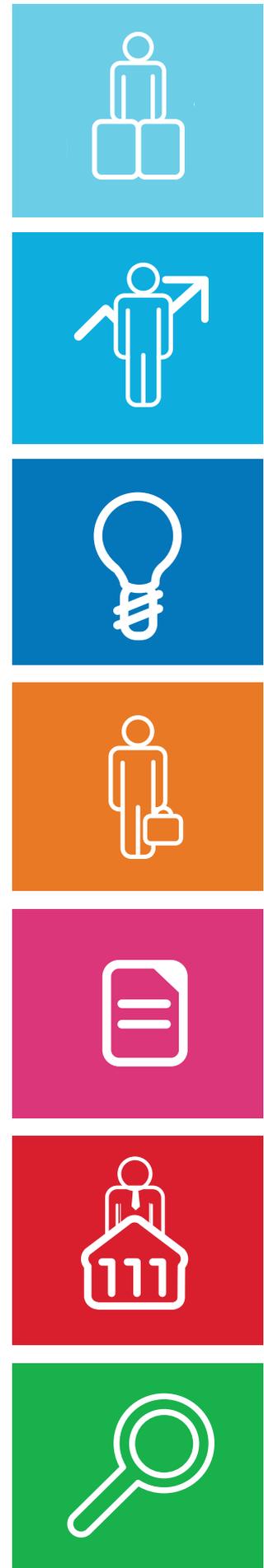
**FIGURE 4.** CRP Team Evolution



# CONCLUSIONS

All the innovative changes in CRP's internal processes, team structure, and investment process have come from its experience in funds management, especially the experience derived from the growth and performance problems of small companies—problems that experience has shown exist in larger companies as well. CRP is getting superior results in many areas and is more prepared to lead new investments because of all the improvements that have been made, beginning with a better prepared team. CRP's pioneering efforts in the Private Equity and Venture Capital industry in Brazil were, and still are, important differentiators in the market. More importantly, its experience in the innovation improvements affected in all its processes, have prepared CRP to avoid hurdles along the way.

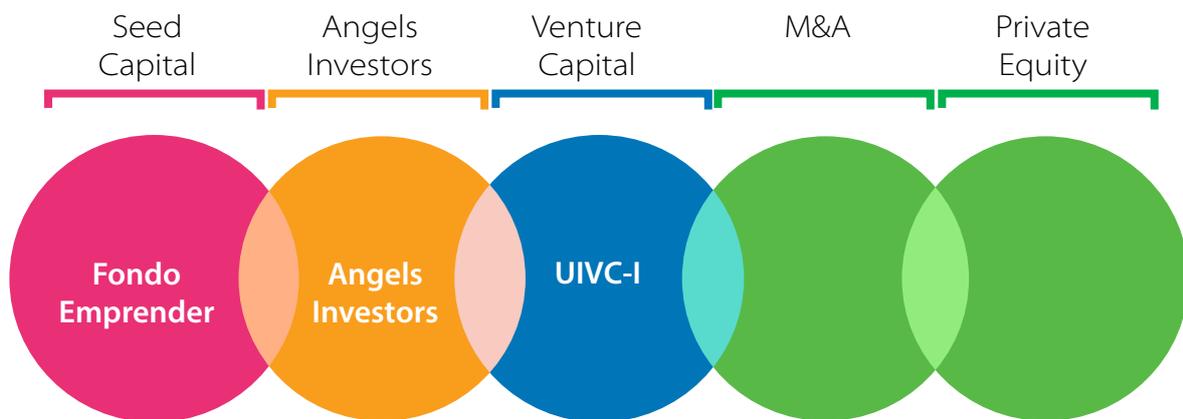
The RSTec Fund results were an important example of the perseverance of CRP's team. Against all odds (vintage 1999), the CRP team managed to recover many of its investments and delivered very good returns. The Fund received an award from IDB as the best Turnaround Fund in 2011 and is expected to return a multiple of 1.5 times invested capital. Since the RSTec Fund, CRP has closed seven more funds.



# A CHANGE PROCESS CASE AT PROSPERITAS CAPITAL PARTNERS

## INTRODUCTION

Prosperitas Capital Partners<sup>3</sup> is a financial management company that has established the first Venture Capital Fund (UVC-I - 2005), the first Seed Capital Fund (Fondo Emprendedor - 2007) and the first experiences of Angel investing in Uruguay.



The funding of early stage companies and venture capital activity in Uruguay has grown considerably since 2005, but there is still room for further development. In our 8+ years in early stage venture capital, we have learned how much hands-on work is needed to make a company succeed in our region. These years of experience made us identify three areas in which we, as a venture capital firm, need to reinforce our investment strategy and staff. These include:

- 1 Identify the risk of insufficient management skills/awareness required in each stage of development of an enterprise. This factor is necessary but not sufficient for a portfolio company's success.
- 2 Choose entrepreneurs with energy, passion and—most importantly— openness to feedback that will accelerate the company's growth. This factor complements the previous one.
- 3 As a venture capital firm, be prepared to provide financing structures and follow-up financing adapted to the state of development of the country's entrepreneurial ecosystem.

<sup>3</sup> [www.prosperitascp.com/](http://www.prosperitascp.com/)

# THE LESSONS

1

## FIRST LESSON LEARNED

### LACK OF MANAGEMENT SKILLS AND HOW WE TRIED TO SUPPLY THEM.

The number and quality of entrepreneurs is expanding in our country and success stories such as CEPA<sup>4</sup> and PedidosYa.com<sup>5</sup> are spreading not only throughout Uruguay but also all over Latin America. As is inevitable in venture capital, however, not every company has been a success.

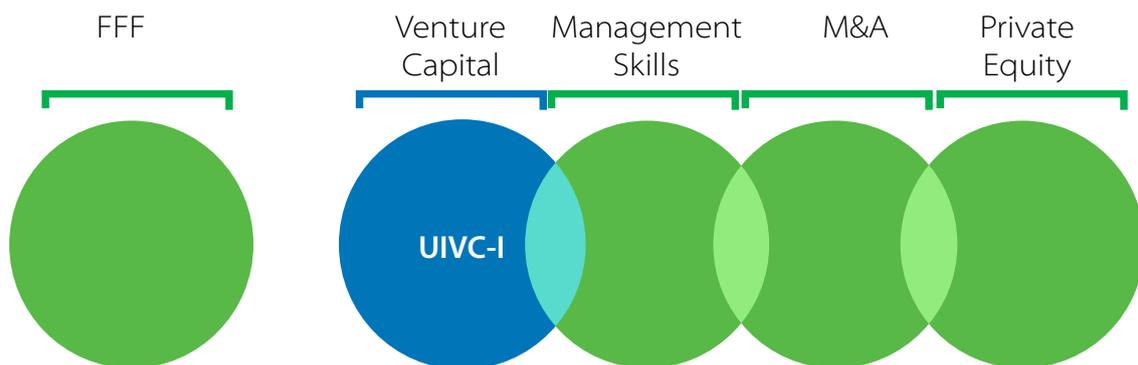
In both of our funds, we have seen several cases of promising companies with an interesting business model and identified customers that did not ultimately prosper. Seeking to diagnose the reasons why these companies failed, we realized there are different risks at different stages of a company's development, although risks related to lack of basic management skills appear in almost every case. Most of our local companies have shown vulnerability in terms of execution and management issues related to selling skills and basic financial planning. The reason is that entrepreneurs often lack basic business knowledge and therefore design a weak business model or establish an ineffective strategy to reach customers.

In 2005 when we launched our first fund, UIVC-I, we had not identified this risk. Moreover, we believed that we would probably change or reinforce the management team some years after we invested, at the time that we prepared the company for its next level. This assumed, of course, that there would be a basic management team available.

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2004 Premises to start VC in Uruguay

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Instead we discovered that while financing became more available in Uruguay, developing management skills became the real growth bottleneck. There was no ecosystem that helped enterprises develop these skills; furthermore, UIVC-I was the first experience of active investing in Uruguay.

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4. [www.cepasafedrive.com](http://www.cepasafedrive.com)

5. [www.pedidosya.com/](http://www.pedidosya.com/)

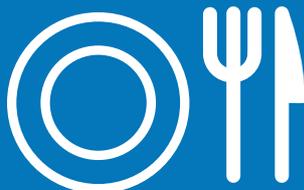
After investing in several companies with high potential but poor execution, we realized we needed to be involved in their management. In the case of UIVC-I, we implemented both monthly board meetings and weekly business counseling and coaching encounters to train the team on basic management skills. The aim of these sessions was to develop reporting discipline with KPI's, create a human resource structure, and provide selling skills and techniques, among others.

## CASE: CEPA Safe Drive

specializes in road security, accident prevention and fleet management for domestic and multinational companies, and governments searching to optimize their automotive fleets (for small, medium or large vehicles). Founded in 1987 by a group of traffic safety engineers, technicians, and experts, the company was not capitalizing on the market's high potential. In 2007, the company stopped growing altogether. This made the entrepreneurs seek external advice. First, CEPA became an Endeavor company, which helped management consider the importance of planning for growth. When the company started conversations with Prosperitas in 2008, it did not have a sales force or a commercial strategy. In 2009, UIVC-1 invested in CEPA. Recognizing these shortcomings, two of the UIVC-1 partners generated a fresh vision for the company's future. An organizational restructuring created a solid management team with the skills to face the new challenges.

In 2007, when we launched the seed capital fund (Fondo Emprender) we knew we needed to work closely with the companies on management development. Our challenge involved how to do so without a considerable increase in operational expenses for our fund. Our first solution was mentoring. We assigned one of Prosperitas' partners or someone in our close network that had related expertise along with an analyst to follow up each of the 20 start-ups in Fondo Emprender's portfolio. The mentor and the entrepreneur met on a monthly basis to analyze the company and brainstorm new ideas to address challenges. After one year with this plan, however, we did not notice any significant changes in the companies' performance. We discovered that in most cases, the entrepreneurs kept working in their old ways without regard to the advice received. There was a breakdown between the recommendations supplied once a month by the mentor and the actions that the entrepreneur had to take on a daily basis. Mentoring was not enough, we found out we needed to take a more pro-active approach with more frequent involvement in the execution to get results.

Some companies, though, required earlier support to capture the angel's interest. Often, angel investors looked for the entrepreneur's concept to achieve some basic traction before getting involved. Therefore, we recognized that we needed to take a further step and incorporate basic management skills as a service in a new financial instrument that could scale. We needed to add these skills to our staffing, as big private equity firms do. The question was how to provide a senior team advisory service without stressing the financial instrument or the target company.



Despite the general poor results, though, some of the 20 companies did show improvement. Where companies realized that the mentor added value, they wanted more of his time, which led to his investment as an angel. Mentoring itself was not a big success, except in those cases where the mentor expected to eventually invest as an angel. The sense of belonging and contributing not only with time, but also having a stake in the business, made the big difference in the company's early stages. Fondo Emprender's team played a key role by matching the needs of the company with the mentor's profile and facilitating the process by working with them in the investment agreement.

## CASE: PedidosYa.com

is a leading online food ordering service in Latin-America. The company provides a service that allows users to quickly find restaurants with home delivery and order food online. Ariel Burschtin, Ruben Sosenke and Alvaro Garcia, three ORT University students, founded the company. It received a grant from Agencia Nacional de Innovación e Investigación (ANII) to develop a prototype with support from the University (providing only technical mentoring). After the platform's development, the next challenge was commercial. The entrepreneurs managed to capture the attention of Kentucky Fried Chicken Chile, which became the first client. In October 2009, Fondo Emprender approved a non guaranteed convertible-loan to the company and placed Rodolfo Oppenheimer, one of the Prosperitas partners, as the mentor. Rodolfo invested in the company in 2010. During his interactions with the company, he prepared it to receive an international round of financing and coached the team for every meeting that took place with the international investor. As of 2011, the company has raised two additional rounds of funding and is planning the third. It operates in six countries within Latin America: Uruguay, Argentina, Chile, Brazil, Colombia and Puerto Rico, and is currently working with more than 3,700 restaurants including major brands such as Burger King, Kentucky Fried Chicken, Denny's, California Burritos, Benihana, Romario and Itamae Sushi.

## CASE: Biogenesis

emerged in 2002 as the first Latin-American company to produce top quality temperature and oxygen saturation sensors, as well as electrocardiogram cables for medical use. In 2008, Fondo Emprender financed the company to achieve international certifications. In early 2010, Biogenesis had to decide whether to build a plant in Europe or Brazil. The decision involved a strategic analysis and Prosperitas suggested that the company start working actively with a mentor. One of the entrepreneurs was reluctant to receive angel investment from the mentor due to a negative experience with a previous partner in a previous company. After some months working together, however, the entrepreneurs decided that the mentor was an asset and they wanted him more involved. By December 2010, the mentor invested in the company. As of 2012, Biogenesis exports to more than 28 countries and is finishing the plant in Brazil.



## WHAT DID WE DO WRONG AFTER ADDING MANAGEMENT SKILLS?

In several companies, adding management skills (with Prosperitas' partners in the case of UIVC-I or mentors in the case of Fondo Emprender) did not generate the expected results. What happened in these cases? We determined that adding management skills was not a sufficient condition for success. We needed to rethink the overall profile of the entrepreneurs in.

### CASE: Memory develops and commercializes ERP

solutions for small enterprises using a franchising model. Memory's set of products aims to solve all the management needs for small enterprises, including accounting, reporting, and human resources. In 2007, UIVC-I invested in the company with the objective of scaling it throughout Latin America by entering each new market, consolidating it, and then moving on to the next one. Our principle directive to the entrepreneur was that the company needed to achieve basic traction in each market prior to accelerating growth. This recommendation was not heeded and Memory was written off in 2011.

This second factor consists in identifying entrepreneurs with energy, passion and openness to feedback, with the added aptitude of being able to assess the most relevant advice received. Entrepreneurs who proactively listen and then seriously consider and analyze the advice received, are an additional necessary condition for reaching success. The key factor in a company's success is not only the idea or the business model, but the team's capacity to execute the plan relentlessly and make the necessary adjustments as needed. As the saying goes, "Ideas are cheap; execution dear."





## CASE: A fishing-tech company

which provides technology solutions to improve the fishing industry. A sea captain, who developed the first version of the product to simulate the trawls while fishing, founded the company in 2000. In 2008, Fondo Emprender approved a USD 50,000 non guaranteed convertible loan to help the fishing company update the software and start commercial activities. The main reason for approval was the product's innovativeness and potential, although we knew we needed to build a company around it. In 2009, the Uruguayan fishing company partnered with one for the world's most recognized brands in professional fish finding equipment to develop software that simulated in 3D the behavior of the instruments while fishing. The partner was going to commercialize the product worldwide and share the revenue with the Uruguayan company. The entrepreneur and CEO did not know how to manage the relationship with the partner and the software's development took longer than expected due to inefficient use of capital and human resources. Prosperitas' team was deeply involved in trying to help the entrepreneur manage the company to fulfill the requirements of the agreement. After several problems between the entrepreneur and his staff, we suggested to hire a new CEO to end the development and be able to start the commercialization. The entrepreneur did not accept and after several disagreements with the partner, the Uruguayan entrepreneur ended up selling them the intellectual property that had been developed because he could not fulfill the agreement. This helped us to understand that a good product is not the key; it is the team that makes a good company.

## THIRD LESSON LEARNED

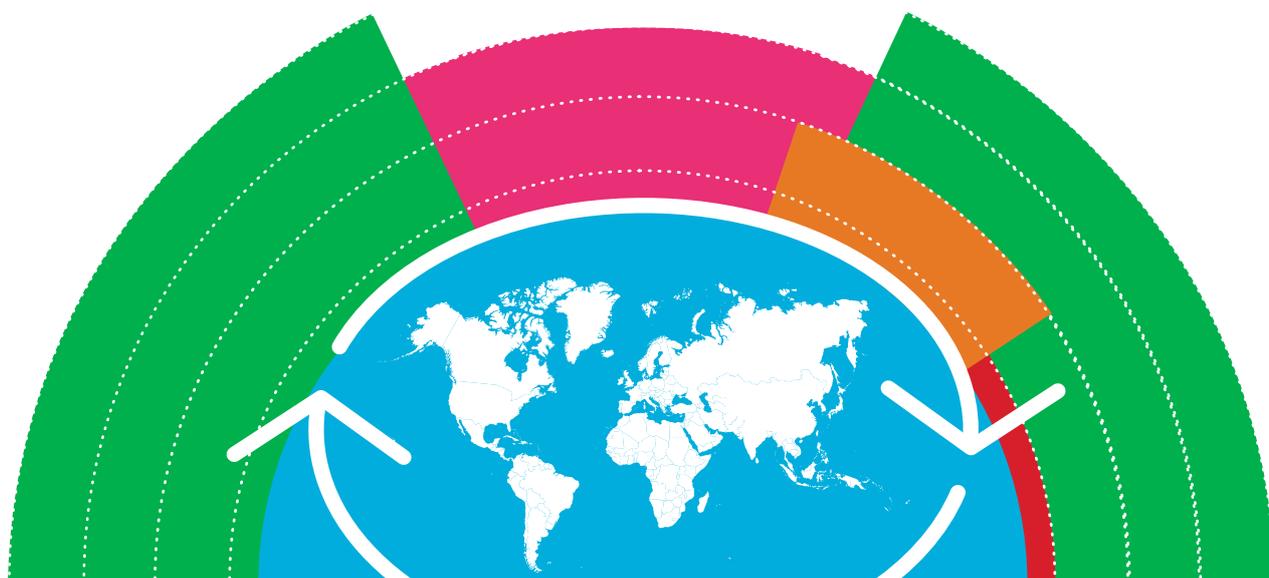
**A VENTURE CAPITAL FIRM NEEDS TO PROVIDE FINANCING STRUCTURES AND FOLLOW-UP FINANCING ADAPTED TO THE COUNTRY'S ECOSYSTEM**

The third factor reflects the evolution of the venture capital firm itself, as the entrepreneurs and the ecosystem develop. We are convinced that our financing instruments have to adapt to the development status of our region, as described below.

The experience of UIVC-I in 2005 showed that neither the entrepreneurs nor the ecosystem were ready to have valuations placed on a company. The majority of the companies in the UIVC-I pipeline were not familiar with the idea of valuation or investment conditions. Furthermore, there were no examples of venture capital investments in Uruguay. From Prosperitas' side, this first fund helped us to understand and create an investment process adapted to our country's maturity level. The concept and instrument of venture capital was innovative for our country and that resulted in a long investment process as we educated the entrepreneurs about the fundamentals of the asset class.

Based on that experience, when designing Fondo Emprender, we decided to change the investment instrument and provide seed capital up to USD 50,000, implemented as a standardized convertible loan. This instrument made the process quicker, reduced operational expenses per company, and was adapted to the 2007 market context.

The loan to equity conversion condition triggers when an angel invests and converts on the same terms and conditions as the new investor negotiated. This structure did not provide the capability to do follow-up financing to further leverage the angel's investment.



In 2012, the reality is different. Angel investing is becoming more widespread and some acquisitions are starting to occur; therefore, we need to update our instrument for several reasons. First, Fondo Emprender did not monetize the risks it took in the early stages because we converted at the same conditions as the new investor, even though we nursed the company not only with money but also through mentoring. Secondly, when there was an exit without a previous investment round, we did not have an upside. Third, we couldn't follow-up with investing in the most promising companies (e.g.: PedidosYa.com and Biogenesis). This is a new area of adjustment for the next financial instrument we are designing. The design of this new instrument will include the lessons learned from both funds and improve on them.



## CASE: CROVAT

Since 2007 the company has been developing and promoting sites, blogs and communities on the Internet. Currently, it owns more than 20 blogs, has a staff of 25 and counts more than 10 MM unique visits to its blogs. It is managed by the founder/entrepreneur. Crovat provides an excellent case to explore the added value presented by the new kind of instrument we are considering. We also sought this entrepreneur's to share his thoughts regarding strategy and organization. In this particularly case, when we invested in Crovat in 2011, our money was not really needed, but the entrepreneur was looking for mentoring and advice. Last January Crovat was contacted by a growing digital media company working in the U.S. Hispanic and Latin American markets and the acquisition occurred this summer. As Fondo Emprender's instrument consists in a convertible loan and its conversion is triggered when an angel investor invested in the company, we did not share in the proceeds of this transaction—which would have been significant. Now we know a convertible loan needs to be more flexible and include other possible scenarios as conversion triggers (e.g. acquisition). Fortunately this entrepreneur is willing to show his recognition of our advisory role in this transaction and will pay Fondo Emprender a support fee as a percent of the transaction.



# CONCLUSION

During these years, Prosperitas has begun a cultural change in Uruguay's investment practices. Our experience shows that in early stage investing there is a need for investors and venture capital teams to work closely with entrepreneurs to supply not only business knowledge but also management skills. Among the lessons learned we can identify:

As Peter Drucker mentioned in several of his books, "developing countries are not underdeveloped, they are undermanaged"<sup>6</sup> and Uruguay is not an exception. We had to provide strong support for basic management skills from the beginning. A skillful management team can make all the difference by providing foundations through management and leadership (not providing "the fish", but "the rod to fish"). The success cases in our portfolio are products or services that already exist worldwide and have wide competition. It is the relentless and focused capacity to execute and make the necessary adaptations into new business models that were the key factors for their successful growth.

A good management team does not succeed on its own. The key factor in a company is not only the idea or the business model; it is the team's capacity to execute. The personal characteristic shared by those teams who succeed is an open attitude toward receiving feedback and the capacity to discern and implement the appropriate portions of the advice received.

A venture capital firm in this region should evolve to optimize on these opportunities. The firm's venture manager must find innovative ways to inspire the companies and their management teams to make them highly profitable. Moreover, the firm must also be willing to evolve and adapt its financial instrument to keep pace with the changing venture market in such a way that aligns interests among all parties and reward the firm (and its limited partners) for the risks incurred. Prosperitas has been the only source of smart money in Uruguay and has to evolve this concept according to the entrepreneurs' needs.

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