

> THE MULTILATERAL
INVESTMENT FUND:

LESSONS LEARNED

**BUILDING A LOCAL
VENTURE CAPITAL
INDUSTRY**

**IN LATIN AMERICA AND
THE CARIBBEAN**

> 15 YEARS INVESTING IN THE REGION

BY SUSANA GARCIA-ROBLES / MULTILATERAL INVESTMENT FUND

Established in 1993 as part of the Inter-American Development Bank (IDB) Group, the Multilateral Investment Fund (MIF) was created to develop effective approaches to advance private sector development, improve the business environment and support micro and small enterprises in order to promote economic growth and poverty reduction in the Latin American and Caribbean regions (LAC) exclusively.

Drawing upon a resource base of \$2.2 billion in assets, the MIF works with governments, NGOs and financial intermediaries, using a range of instruments including grants, loans, guarantees, equity and quasi-equity.

The MIF's unique mission to contribute to private sector development led the institution to get involved in building a local venture capital (VC) industry. At the time the MIF started investing in seed/early stage VC in 1996, VC was virtually non-existent in LAC, since the few funds operating in the main countries in LAC were private equity (PE) and international (Advent, Westphar, etc). Later, the MIF helped rebuild VC in the Region after the dot-com bubble burst in 2000. Throughout these 15 years, the MIF never retrenched from the Region, in spite of other investors –including development agencies—doing so.

Most development financial institutions (DFIs) tend to diversify risk by investing in a mix of growth capital and private equity, supporting fund managers with well-proven track records. The MIF's focus is on discovering first-time fund managers who show great potential, help them build a successful track record, and jointly develop a LOCAL VC industry that invests in small companies run by entrepreneurs who cannot access finance through the conventional financial channels (e.g., loans from banks).

When the MIF started, there was no local institutionalized venture capital in the region. Fifteen years later, with the help of the MIF and its partners, the LAC region is poised to become an attractive destination for investors looking to diversify. Just in Brazil alone, the MIF supported the creation of half the current local management companies today under operation. Some of these managers that in the late nineties did not have any track record, are managing their third or fourth fund today, partnering with international players, and being acknowledged by the industry as successful players.

Today, the MIF has become a focal point for key actors in the industry in terms of advisory services, partnership building, knowledge transfer and networking platforms. The MIF has partnered with over 60 other co-investors, local and international, representing the public and private sectors. It advises local governments on developing venture capital policies to promote the VC ecosystem according to industry best practices; partners with both the public and private sector on regulatory changes to make the LAC markets more attractive to international and local private sector investors (e.g. minority shareholder rights, tax exemptions); shares its know-how in conducting due diligence with other investors; and acts as a platform for entrepreneurs, fund managers and investors to meet and exchange experiences.

What the MIF has achieved with relatively little money – a bit more than a quarter of a billion dollars-- is remarkable.

> Evolution of the MIF Portfolio and Strategy: 1996-2011

The MIF started investing in VC in 1996, three years after it appeared on the development scene. To date the MIF has approved investments in 66 seed and Venture Capital funds that can be broken down in different categories:

- (i) six of them never had a first closing due to lack of investor interest in the LAC region in those early years;
- (ii) seven were terminated early due to poor performance or a change in the fund manager's strategy;

- (iii) nine had poor performance due to design problems from the start, or from the different crises in the region that affected their performance. Most of them have been exited obtaining small returns or at a minor loss; a few are in the process of finishing their lives;
- (iv) thirty-four are active funds which have either finished their investment period and began divesting; or are still investing; and
- (v) ten are in the process to sign legal documents to start investing.

The three first categories became a source of lessons learned which were applied to refine the MIF strategy in the funds that were later created. The last two categories hold the promise, and in a few cases, already the realization, of success in the MIF portfolio.

> Key Lessons Learned from Investing in VC in LAC

↳ *Sustainability*

Without attractive financial returns, there are no “good stories” on positive social and environmental impact. And there are no follow-on funds. In the late nineties, there was a current of social minded investors who thought that subsidizing heavily the industry and accepting non-attractive returns, would still render a successful story in development. The opposite happened. Today, the investors looking for impact consider that attractive financial returns are part of such impact. And they are pushing to consider impact investments (those looking for a triple bottom line of financial, social and environmental returns) as a new asset class.



MAKING VC WORK IN LAC REQUIRES THE DEVELOPMENT OF THE ENTIRE VC ECOSYSTEM



➤ *Fund Size Matters*

In the beginning the MIF targeted small funds and its commitments ranged between USD 5-10 mm representing up to half the size of the fund. As the first funds encountered problems related to their lack of a critical mass to operate sustainably, the MIF aggressively engaged other co-investors so the following funds would be bigger size and could operate with a professional team committed to stay for the fund's life. Today, according to the size of the countries in LAC, the minimum critical mass for a VC fund ranges between USD 20 to 50 MM. This is needed to provide several financing rounds to small and medium enterprises (SMEs) and to retain skilled staff at the fund management company level. Since every country in the LAC region has very few seed and VC funds, each fund should have enough capital to provide several rounds of financing to the best SMEs and not rely that there will be other funds providing subsequent rounds, as it happens in the U.S. and other developed markets.

➤ *VC is Patient Capital*

Part of the MIF's credibility as an investor is that it has been a "constant" throughout the different crises, learned from early mistakes and shared those lessons with the market. Today, its portfolio is beginning to show the fruits of such endurance. It's all about patient capital and staying through the ups and downs. This is a cyclical industry and it pays off not to be opportunistic but to keep a long-term vision.



STATUS OF VC **ECOSYSTEMS IN LAC**

Most developed VC ecosystems

BRAZIL, CHILE, COLOMBIA, PERU

- ▶ Most promising VC ecosystems
- ▶ Acceptable legal, tax and regulatory frameworks in place
- ▶ Fund Managers with track records
- ▶ Local capital markets and strategic exits possible
- ▶ Numerous 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

Moving toward conducive business and/or regulatory Environment

MEXICO, URUGUAY, ARGENTINA, COSTA RICA

- ▶ Entrepreneurship is flourishing
- ▶ Angel groups starting
- ▶ Incubators are commercializing
- ▶ Entrepreneurs starting to understand VC
- ▶ Corporate governance and accounting 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

Currently do not have conducive business and/or regulatory environment

PANAMA, BARBADOS, BAHAMAS, JAMAICA, SURINAME, TRINIDAD & TOBAGO, BOLIVIA, PARAGUAY, BELIZE, DOMINICAN REPUBLIC, EL SALVADOR, GUATEMALA, HAITI, HONDURAS, NICARAGUA, ECUADOR, GUYANA, VENEZUELA

- ▶ Early stages of 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 offshore funds are possible
- ▶ DFIs and foreign 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 levels of entrepreneurship
- ▶ Few incubators
- ▶ Quality of accounting standards is ambiguous
- ▶ VC and seed investing not well-known

➤ *VC is All About Diversification*

The MIF does not have any country restriction, except for its mandate to operate exclusively within the LAC region. This results in a good diversification across geographies in Latin America (Central America, the Caribbean, Southern Cone, and the Andean regions). The MIF has supported regional, country-based and state-based funds. It can invest in a variety of sectors as long as they target small companies with growth potential (e.g., the MIF does not invest in infrastructure or real estate funds). This has been a comparative advantage over other DFIs that have investment restrictions which limit their focus to invest in the poorest countries of the region, which often do not provide the enabling ecosystem for VC.

➤ *Skills Are a Key Element to Success*

The due diligence should focus on the fund management team because the differentiating factor in fund quality is the fund manager's skills. Same with the investees: anyone can download a business plan and financial projections from the Internet, but who will carry out the strategy is what matters. An early lesson from the MIF was that NGOs generally do not make good fund managers. They lack the much needed financial discipline to support SME growth and often times they are only focused on the vision/mission of their charters. This is an important lesson when investing in environmental, tourism and agribusiness funds: if the team is housed within an NGO, the investor should carefully analyze if such team will be able to provide the financial support that the companies need. An ideal combination is the model now supported by the MIF in this type of fund: a management company that is equally composed of financial and sector experts in the team.

➤ *Ecosystem*

Without a conducive ecosystem, there is no continuum in the financing chain (angels, seed, early VC, growth capital, PE) and SMEs cannot maximize their potential. Improving the regulatory and legal environment is essential to attracting investors. What usually comes to mind is the Silicon Valley ecosystem, unique in the world, and trying to be replicated elsewhere with different results. But the Silicon Valley model is not a good fit for LAC overall; a few areas in countries in the region provide the needed ecosystem for dynamic entrepreneurship. LAC VC, overall, is less focused on disruptive technologies and life sciences, and is less likely to

obtain attractive returns from one “home run” investment and IPOs, with the exception of few countries or regions that present more opportunities in technology and biotech- Argentina, Brazil, Colombia, Mexico, and Uruguay (see graph on developing an enabling ecosystem for VC on page 4, and how countries in LAC are ranked on page 5). Some of the companies invested by seed and VC funds exhibit high growth potential, in promising sectors and/or in companies with innovative products or services, and follow a path similar to the ones found in Silicon Valley.

However, the majority of companies in LAC that could grow to become a success story do not belong into this group. These companies come from the traditional sectors of the economy: retail, services, manufacturing, and agribusiness, to name a few. Fund managers in LAC are usually looking for good results across the whole portfolio, instead of one home run that will deliver returns for the rest of the investments. This is a major consideration for anyone looking to invest in LAC: if you go with the idea to find the next Facebook or LinkedIn, you will be restricted to look only in some pockets within Brazil, Argentina, Chile, Colombia, and Mexico. If you go beyond the U.S. concept of venture and discover other sectors where VC is applied as a tool to invest in more traditional sectors, your chances of having success will increase. Family Offices from the Middle East have realized this and are eyeing the LAC region, especially for agribusiness deals.

➤ *Sector-specific Funds*

VC may not be the right tool for some sectors that pose too many risks outside the fund manager’s control (for example, tourism funds); but VC can be right for sector-specific funds in more developed markets in LAC (e.g. technology in Brazil, agribusiness in the Southern Cone). The LAC VC model seems to work better when funds focus on more than one sector.

➤ *VC is An International Business*

Bridges between LAC and other markets need to be strengthened to facilitate exits and attract foreign investors. Networking is a powerful currency: management teams well connected are more successful in fundraising, developing sound deal flow and exiting successfully.

➤ *VC Requires Full Commitment*

Managing VC funds should be the fund manager's sole source of income, and fund managers should be fully dedicated to VC. Incentives should be aligned within the management team, and with the investors. For first time fund managers this may translate into having a team composed of partners with deep pockets, who can afford a first fund that may only deliver returns to the investors, but secure their follow on funds.

➤ *Successful First-time Fund Managers Must Have's*

The MIF has developed an expertise in discovering talent among new fund managers. These teams are often overlooked by the industry, since they don't exhibit the expected traditional track record of successfully having divested from earlier VC funds. The main characteristics of the Principals in these teams, validated especially by the success stories obtained by the MIF investing in Brazilian first-time fund managers who today are recognized globally as important players, are: (i) partners who have studied or worked overseas and have been exposed to the industry in developed markets; (ii) partners who returned to their countries with a life project to start its own management company; (iii) partners who seek other friends as committed as they are to start the venture; (iv) partners who have been successful and have deep pockets, capable of affording a first fund that may only deliver attractive returns to their investors, but will secure their following funds; (v) partners who have a deep network, both local and international, that will be key to their success in fundraising, developing a sound pipeline and exiting; and (vi) partners who gather a team with diversified skills: entrepreneurial, consulting, financial, commercial and operational, as well as expertise on the sectors targeted by the fund.

➤ *VC Should be a Private Sector Led Industry*

The MIF's investments are leveraged overall at a ratio of 4:1. Today, every dollar invested by the MIF in a fund mobilizes \$4 in additional fund resources. Recognizing the importance of catalyzing private sector participation in the industry, the MIF fund commitments are usually contingent upon additional private sector commitments being raised by the fund manager. The exception to this rule would be when entering a country at an incipient stage of VC development where the multilaterals and government agencies are almost the only ones

willing to get involved and help build the industry, until there are enough success stories to attract private sector investors. The MIF followed this path in Central America: the first funds had only public investors. Last year, the MIF approved an investment in a Central American fund that has 25% ownership by investors representing Family Offices.

↘ *Exits*

Contrary to what was happening in the developed world, attractive exits were being consummated during 2008-2010. Some of the companies owned by these VC funds were acquired by US and UK companies searching for talent in the Region, others were acquired by local companies that had done an IPO and were consolidating, and a few exited through IPOs. The next two years will be key for measuring success, as many of the active funds will be exiting.

↘ *Evaluation Tools*

Finally, the MIF always allocates its own resources to fund independently conducted evaluations on the funds it invests. These evaluations have been key to early detection of problems and compilation of “what works and what doesn’t work in LAC VC.”

> 2010 AND FORWARD: A RENEWED MIF-OUR ROLE GOING FORWARD

The MIF went through a small restructuring during 2010. What it had accomplished since 1993 was significant. In seventeen years, the MIF had become a force in the Region, mainly due to its mandate for high risk and innovation, and the possibility to provide equity, a much needed instrument in LAC. The decision to focus on some lines of activity more than in others was based on a hard look at the areas in which the MIF could be most effective and contribute to systemic change in the Region.

Out of that exercise, it was clear that MIF's guiding principle should be all about improving access, and from there three main areas of action were devised:

- » ACCESS TO FINANCE
- » ACCESS TO BASIC SERVICES
- » ACCESS TO MARKETS AND CAPABILITIES

Within the Access to Finance, the MIF commitment to keep developing VC is just as strong now as in the first years of the MIF. Its goals then and now are the same:

- » Develop local Fund Managers as well as local capital markets
- » Support local small companies that are promising and can be grown to become global
- » Support the development of the private sector by engaging them as investors

To accomplish these goals, there are three specific lines of action: (i) investments in seed and VC funds that follow both a more traditional Silicon Valley strategy or a traditional sectors strategy ; (ii) investing in funds that bet on the potential offered by green technologies and their application, and by the growing population at the base of the pyramid, traditionally overlooked by business but with a potential to become the greatest force in emerging markets during the next decades; and (iii) grants to work with the private and public sectors to create enabling environments for investing.

Going forward, the MIF is focusing on disseminating in a more systematic way its lessons learned from investing in LAC, and concentrating on what we can learn from every project we approve.

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