The Multilateral Investment Fund - Supporting the Creation of a Venture Capital Industry in Latin America

Public Policy Forum on Venture Capital

Quebec City, October 25-26, 2010

Susana Garcia Robles – Lead Specialist
MIF Early Stage Financing Program
for Latin America and the Caribbean

FOMIN

Multilateral Investment Fund
A Member of the IDB Group

Table of Contents

The Multilateral Investment Fund

- **A member of the IDB Group since 1993**- part of the Private Sector Window with 38 donors (beneficiary and non-recipient countries, China is a donor country) Within the IDB, the institution with the highest appetite for risk and innovation

- **The largest technical assistance and equity provider to the private sector in Latin America and Caribbean** - US$80-100 million per year

- **Synonymous with clear development impact** - over 4 million small producers and micro entrepreneurs reached

- **A recognized track record** - 590 completed projects, 87% of which achieved their development goals

- **A cutting-edge innovator** - testing and rigorously evaluating new business models to take private sector to the next level

The MIF works with governments, NGOs, Foundations & private sector companies as…

- **The 'knowledge broker and hub' of a large network of local & international partners** - 650 partners that share FOMIN goals

- **Provider of grants, loans and equity investments** - average grant size of USD 1.5 million

- **The gateway for extensive knowledge and expertise** on private sector solutions for LAC MSMEs and entrepreneurs

MIF is about leveling the 'Access Playing Field' to empower economic activity, growth and a way out of poverty

Access to Markets

- Business Capabilities
- Market Functioning
- Job Skills

Access to Finance

- Microfinance
- Venture Capital
- SME Financing
- Financial Services

Access to Basic Services

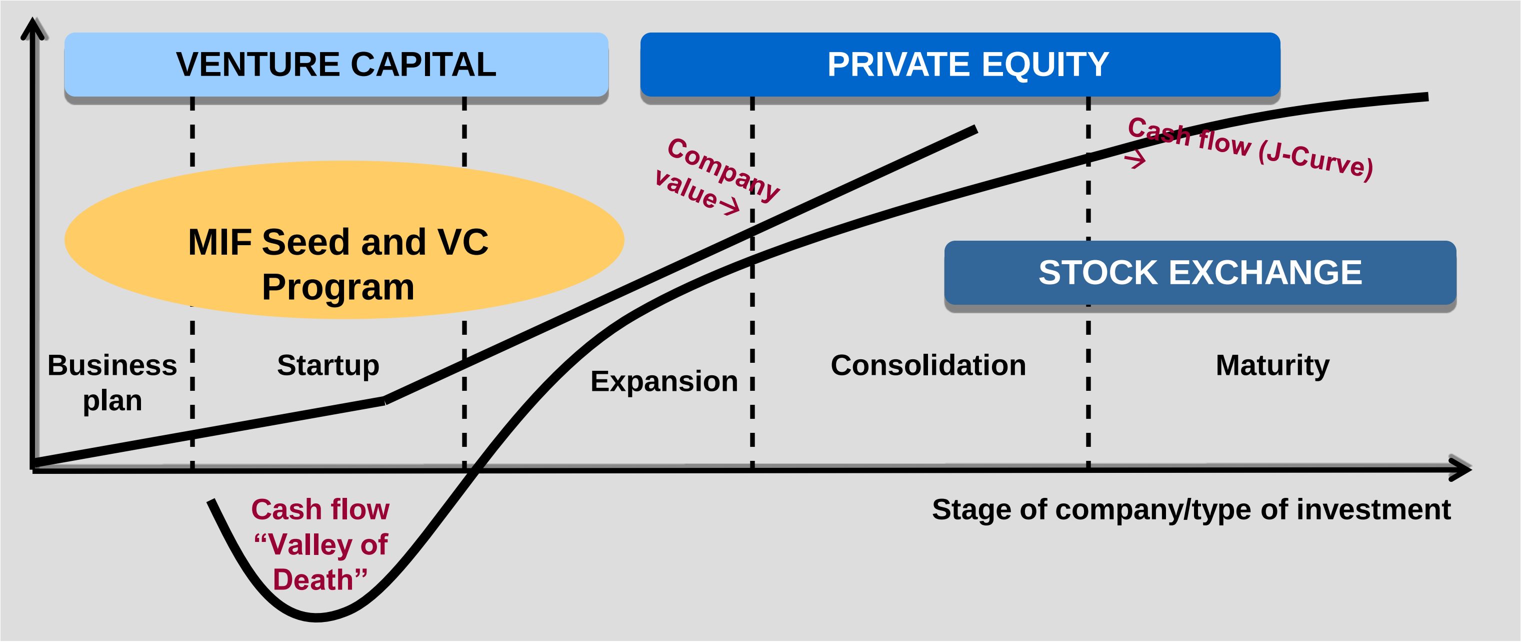
- Climate Change
- Private Sector engagement in basic services

➢ In Venture Capital, as part of Access to Finance, the MIF utilizes both grant and equity financing to promote private sector development and entrepreneurship. Few DFIs have this double pronged approach

Table of Contents

How VC Investment Works

- **Long-term -** typical fund life is about 10 years
- **Hands-on -** fund managers work in partnership with entrepreneurs to make SMEs grow
- **J-Curve pattern of returns -** funds present a negative IRR (return) in the first years while a fund makes investments, but the returns improve as fund starts exiting from investments



How Does Venture Capital Provide ACCESS?

Actors - Working in partnership with VC industry actors to reach MIF's goals

Catalyst - Catalyzing investment to LAC from the public and private sectors

Capacity - Building skills and capacity of entrepreneurs, SMEs, VC funds, investors and regulators

Entrepreneurs - Empowering local entrepreneurs

SMEs - Investing in and formalizing business activities of SMEs; contributing to the growth of SMEs that participate in the LAC knowledge economy

Sharing - Disseminating lessons learned; reaching the key actors

Venture Capital Transforms

- **Finance** - offering new ways to finance entrepreneurs ' ideas and companies through equity, quasi-equity and convertible loans

- **Growth** - Job creation, rising incomes and resulting GDP growth contribute to poverty alleviation

- **Skills and Capacity** - VC fund managers improve SME management, operations, corporate governance, auditing and finance practices

- **Partnerships** - VC fund managers are long-term, hands-on investors who work in partnership with entrepreneurs

- **Development** - VC stimulates sustainable development of the private sector and the knowledge economy

- **Markets** - VC develops markets by turning entrepreneurs' ideas into useful products and services

VC Makes a Developmental Impact Globally

- In 2008, US companies that had been backed by VC funds at some point accounted for 21% of GDP (USD 3 trillion in revenue) and 11% of private sector employment (12 million jobs)

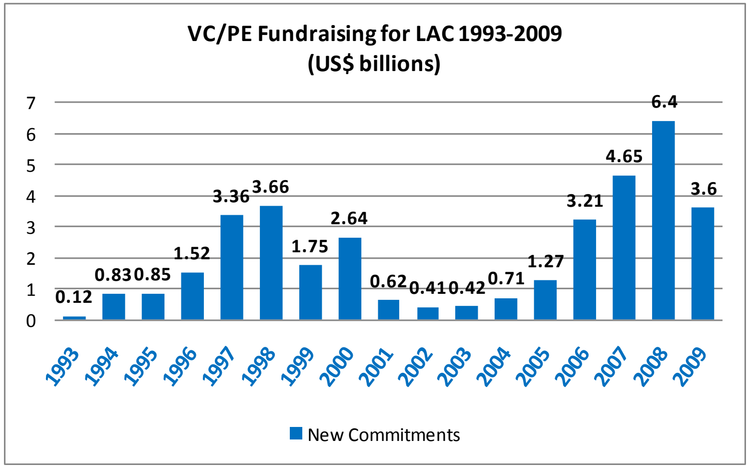
- In South Africa, average employment growth rates at VC/PE backed companies were 10% per annum, compared to 1% across all businesses

- In Ireland, companies backed by VC funds have been increasing revenues on average by 21.6% per annum since 2003

- In Israel, where VC has been key to economic diversification and building of knowledge-based sectors, 40% of software and electronics products are produced by companies that had been backed by VC funds at some point

Growth of Venture Capital and Private Equity in LAC

- VC has existed in LAC on and off since the mid to late 1980s, with Brazil, Argentina, Chile and Mexico leading the industry- Focus was mature stage/private equity
- The growth of these early funds was funded largely by local government agencies like BNDES (Brazil) and NAFIN (Mexico) along with the MIF (since 1994)
- MIF entered the industry in 1996, when VC was virtually nonexistent in LAC, and helped rebuild VC after the dot-com bubble burst in 2000
- In 2008, USD 6.4 Bn was raised for VC/PE investment in LAC, while USD 4.6 Bn was invested by VC/PE funds in LAC



Growth of Venture Capital and Private Equity in LAC

- **MIF has been instrumental** in developing the VC segment from virtually nothing - VC now accounts for an estimated USD 900 mm of the VC/PE fundraising in LAC

- **MIF is a catalyst** - its investments are leveraged about 4:1

- Internet boom and bust changed the industry's landscape for almost a decade: the bubble to bust cycle followed US crash, it showed cracks in the industry in LAC as
  - Performance very poor as US style practices not entirely transferable;
  - Inadequate legal and regulatory structures
  - Less mature entrepreneurial culture
  - Lack of depth in fund manager industry in the region
  - Lack of jurisprudence and disclosure issues a challenge

- After 2003, re-building from the ashes; in 2006 and 2007: entering another, more mature and sustainable boom in some countries

- **Numbers speak:** Fund raising over USD 3.6 billion in 1998, following to USD 407 mm in 2002 reaching a gradual recovery to pre crisis levels with USD 3.1 billion in 2006, by 2008 reaching a high of USD 6.4 Bn, and falling to USD 3.6 Bn in 2009. (VE-LA Mid-Year report 2007, LAVCA Industry Report 2010)

- To a large extent, VC is still a nascent industry in the Region, but a few countries are showing signs of a more mature industry

Developmental Impact of MIF VC Portfolio

- As of 2008, MIF's investments in VC funds have helped finance **290+ SMEs** and support **16,000+ jobs**

- In 2008 alone, **portfolio companies generated $817MM+** in revenues and $58MM+ in taxes paid by SMEs

- MIF has **catalyzed private and public investment** (e.g. CAF, Norfund, NAFIN, high net worth individuals, pension funds, private banks)
  - including ~$**900 MM** of VC investment from Brazilian pension funds

Indirect Impact of MIF's VC Portfolio

In addition to stimulating direct job creation, tax revenue generation and contribution to GDP by SMEs, investments made by VC funds have a broader impact

- Development of related industries and indirect job creation

- Social impact of portfolio companies' products (e.g. potential development of medicines, vaccines, useful technologies)

- Growth of key sectors such as tourism, manufacturing, agriculture, food production (e.g. CASEIF I & II, Emerge, AgroDesarrollo, Guanajuato)
  - Skills and jobs at different income levels
  - Formalize SME business activity
  - Improve governance, auditing and financial reporting

- Growth of knowledge-based sectors: medicine, software, renewable energy, technology, education (e.g. RESTec, Burrill, Stratus GCIII)
  - Develop high-tech industries
  - Create intellectual property and commercialize scientific findings and inventions
  - Create high quality jobs and fight brain drain by keeping and attracting back to LAC locals with PhDs, MDs, Masters, MBAs, etc.
  - Diversify economies away from commodity-based business activities
  - Catalyze development of business communities focusing on science and technology similar to Silicon Valley, US and Bangalore, India

Developmental Impact Example: CASEIF II (Central America, 2007)

- **Fund status**
  - Impact of crisis felt, but performance is positive
  - Companies expanding regionally, launching products, adjusting strategy and operations
  - Support for young entrepreneurs and workers
  - Improvement of SME competitiveness through ISO and other standards
- **Selected portfolio companies Inalma (Honduras)**
  - Provider of yucca, plantain and fruit products to WalMart, Goya, etc.
  - 257 employees, 66% are 18-30 years old
  - 3,000+ indirect jobs
  - 20+ employees attended high school, technical school or university through Inalma's scholarship program
- **Tecnosol (Nicaragua)**
  - Has installed 48,000+ renewable energy systems (solar, hydro, wind); 270,000 people benefitted
  - Serves clients without access to the electricity network and those seeking energy savings, efficiency
  - 87 employees, 55% are 18-30 years old
  - Carbon offset: 1,539 tons of CO_2

Key Facts

- **Capitalization $29MM, invested $10.33MM** - fund still has 7 years of operations left
- **8 portfolio companies**: 858 direct and 3,050+ indirect jobs
- **58% of portfolio companies' employees** are 18-30 years old
- **1 partial exit** (Feb. 2010): Ceconsa (Nicaragua)
  - 16% IRR
  - Construction company building low- and middle-income housing

Table of Contents

More than 15 years ago, the MIF set out to promote equity as a development tool by:

1. Supporting promising companies through specific programs
2. Attracting private capital for SMEs
3. Promoting technology
4. Encouraging development of local fund management experience
5. Promoting good governance among funds and companies invested
6. Promoting a culture of investing among entrepreneurs
7. Asking for rates of return in line with market expectations
8. Working on developing the capital markets, to improve exit possibilities

- *Our mandate is to support companies in the range between start-ups to companies with up to 100 employees, that can have from zero to a maximum of USD 5 mm in annual sales or assets at the time of our intervention*
- *We stimulate the development of these dynamic ventures and small businesses, by providing loans, quasi-equity and equity through seed and venture capital fund managers specialized in these segments of the private equity industry*
- *We do not invest directly in companies*

Today, the MIF is a VC Leader in LAC

- **Pioneer -** MIF began building the VC industry when there were almost no VC funds in the region
- **Builder of the VC industry through:**
  - Investment in local VC funds
  - TA projects
  - Providing advice to investors new to LAC and to other industry players
- **Committed investor -** MIF has invested in more VC funds in LAC than any other investor
- **Unique among DFIs:**
  - MIF's structure and mandate allow it to take more risks, permitting it to focus on an incipient segment like VC
  - Can invest and provide TA grants, which gives multiple tools for building industry
  - Focus on seed and early stage VC, whereas most DFIs focus on mature VC and PE; this allows MIF to concentrate on developing SMEs rather than large companies
  - Focus on SMEs means that MIF reaches more under-served companies and entrepreneurs

Key Facts:

- **1996- July 2010:**
  - MIF invested in 62 seed and VC funds, representing a USD 280.7 mm commitment
  - Disbursed USD 141.4 mm
- **46 funds are currently active, representing a USD 232.4 mm commitment**
- **Engaged 60+ co-investors**

How did the MIF helped develop the VC industry in LAC?

- **Technical Assistance Programs -** The MIF works with entrepreneurs to position their companies
- **Creation of an asset class -** The MIF supports local management teams and provides them with training on international best practices
- **Angel and Venture Capital associations –** The MIF provides grants to start these regional and country associations
- **Focus on networks –** The MIF has acted as a platform for entrepreneurs, fund managers and investors to meet and share experiences
- **Advisory Services -** The MIF advices governments on regulatory issues and VC industry best practices → improve the regulatory environment for the industry
- **Scorecard on VC Environment -** The MIF worked with The Economist and LAVCA to develop a scorecard ranking the environment for VC/PE investment in 13 countries in LAC

The MIF Value Add in Developing VC

- **Committed Investor –** Has provided capital in 55 seed and VC funds in the LAC region
- **Builder of local capacity -** Has supported the development of new, local fund management companies, helping them acquire fund management skills according to international standards; this is expertise that they passed onto the entrepreneurs of the fund's investee companies
- **Partner with public and private sector -** The MIF has worked with the public and the private sector on regulatory changes to make the LAC markets more attractive to international and local private sector investors (i.e., shareholders' rights)
- **Knowledge Transfer –** The MIF has shared its know-how in due diligence with other investors, creating a pool of knowledge in the region, and shortening the learning curve for this industry
- **Focus on networks –** The MIF has acted as a platform for entrepreneurs, fund managers and investors to meet and share experiences
- **Counter cyclical -** The MIF does not leave the region in spite of volatility, rather, it works harder to convince other investors to stay in the region and have a long-term approach

Elements of a Conducive Venture Capital Ecosystem

Players
- Fund managers
- Pension funds that invest in VC
- Government that supports growth of VC industry
- Entrepreneurs who understand VC investing

Exits
- Local capital markets strong enough to allow exits through IPOs
- Local companies attractive to international strategic buyers

Local SMEs
- Quality SMEs to ensure robust deal flow
- Robust corporate governance
- Satisfactory local accounting and adherence to international accounting standards

Entrepreneurship
- Angel networks starting
- Entrepreneurs actively building companies
- Incubators operating with a commercial approach

Legal and Regulatory Environment
- Stable and well regulated business environment
- Laws regarding VC applied well
- Acceptable tax treatment of VC investments
- Protected minority investor rights

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

Lessons Learned

- **Sustainability**
  - Means attractive financial returns and a positive social and environmental impact
  - Fund size matters (in LAC, minimum USD 30-50 mm) to provide several financing rounds to SMEs and to retain skilled staff at fund management company

- **Skills**
  - NGOs and government agencies generally do not make good fund managers
  - Due diligence should focus on fund management team
  - Differentiating factor in fund quality is fund manager's skills
  - Fund manager should look for "serial" entrepreneurs

- **Ecosystem**
  - Silicon Valley model is not a good fit for LAC
  - LAC VC is less focused on disruptive technologies and life sciences, and is less likely to obtain attractive returns from one "home run" investment and IPOs

- **Environment**
  - Improving regulatory and legal environment is essential to attracting investors

Lessons Learned (Continued)

- **Industry support**
  - Support for VC associations is important to raise awareness and attract investors to LAC
- **VC is an international business**
  - Bridges between LAC and other markets need to be strengthened to facilitate exits and attract foreign investors
- **Financial instruments**
  - Quasi-equity and loans are often a better fit for incipient VC markets than equity
- **Exits**
  - Attractive exits through strategic sales are happening despite size of local capital markets, although IPOs yield better returns
- **Returns**
  - Driven by portfolio company growth and increased efficiency rather than leverage or multiples

Lessons Learned (Continued)

- **Sector-specific funds**
  - VC may not be the right tool for environmental and tourism funds; use of grant and mezzanine facilities may be more suitable for these sectors
  - VC is right for sector-specific funds in more developed markets in LAC (e.g. technology in Brazil, agribusiness in Chile)
  - LAC VC model seems to work better when funds focus on more than one sector
  - Base of the Pyramid Funds a new bridge between microfinance and venture capital

- **VC requires full commitment**
  - Managing VC funds should be fund manager's sole source of income, and fund managers should be fully dedicated to VC
  - Incentives should be aligned

- **Evaluation tools**
  - MIF-funded evaluations have been key to early detection of problems and compilation of what works and what doesn't work in LAC VC

Table of Contents

What role for the Government?

- Governments need to promote the industry through technical assistance grants and innovative programs
- The development of a VC industry takes decades; governments should take a long-term approach and implement it despite who is ruling the country, and remain involved in VC/PE funding throughout crises
- Pension funds' investment in VC is key to develop the industry; government should create schemes to foster favorable pension funds' regulation on asset allocations
- Support for capital markets development to facilitate exits (Novo Mercado)
- Promotion of favorable tax and regulatory legislation governing investment vehicles
- Improvement of business conditions: World Bank's Doing Business Report.

Key Facts:

- The development of the VC/PE industry require not only patient investors, savvy managers, a large pool of entrepreneurial talent,

BUT

- a predictable economic environment, good information sources, an appropriate tax and legal system, and active capital markets to allow for exits: how to achieve this should be studied by the different government agencies to include in their strategic plans
- The VC industry also requires clustering and critical mass, supported by the appropriate infrastructure (uniqueness of Silicon Valley); a large base of entrepreneurs, scientists and skilled personnel, assisted by a network of service providers. This process requires a significant financial commitment by public institutions

Developing an Industry in Brazil-Partnership with the Government Innovation Agency FINEP: INOVAR (Brazil, 2001-2008)—an Example of Scaling Up

- **Goals**
  - Stimulate the formation of technology-based companies and help them gain access to capital by facilitating the creation of new local VC funds and fund managers
  - Develop an ecosystem conducive to VC investment
  - Forge relationships among Brazilian and international institutions
  - Increase local sources of capital/investors
- **Number of partners working with INOVAR grew from 4 to 17, 11 of which are pension funds**
- **Fund Process**
  - 11 calls for VC/PE fund proposals
  - 90 due diligences out of 190+ fund proposals
  - 89 investors have participated in panels to evaluate fund proposals
  - USD 1.98 BN committed to 25 seed, VC and PE funds
  - USD 900 MM from 13 local pension funds
- **30 venture, seed and IPOs forums**
  - Average of 25 investors per forum
  - Average of 12 participating potential investees per forum
  - 56 companies received USD 55 MM total in seed, VC and 11 companies received USD 1.4 BN in PE investment
- **Scalability**
  - Cost of first phase of the program (2001-2008) was USD 11 MM, of which USD 1 MM was contributed by MIF
  - INOVAR facilitated USD 1.7 BN in investment for 3,600+ SMEs
  - MIF has adapted INOVAR model for Peru and Colombia
  - FINEP has advised Argentina, Chile and Mexico on replicating INOVAR

Considerations

- For emerging countries, integration with developed countries a must
- Study all the fiscal and regulatory issues that can improve the environment for local and international investors
- Improve all business process that can encourage entrepreneurship: time to open and close down companies, patent registration issues, tax breaks, disclosure issues, etc.
- Investment in training, education, and technology is critical
- Governments should promote a culture of entrepreneurship from the early stages of education
- Governments should work with the private sector to better regulatory and business environments; existence of venture capital associations is important to lobby the government in key issues of the industry
- Promotion of local companies and of partnerships with overseas