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Adding Value Through Venture Capital in Latin America and the Caribbean

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Adding Value Through Venture Capital in Latin America and the Caribbean

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Executive Summary

Venture capital (VC) investment has long been recognized as an engine for economic growth and development. Unlike bank loans, where the entrepreneur receives money and is left alone as long as the payments arrive on the pre-arranged schedule, venture capital investments add the quality of active investing to the cash infusion. In exchange for taking on the risk of young companies in uncertain environments, venture capitalists receive board level oversight privileges, which range from approval of budgets and advice on product development to the right to replace the management team should they consistently under-perform. This activity, performed by individuals with substantial experience in shepherding young companies to maturity, creates substantial value in the portfolio company.

The process of value creation starts with the choice of a promising company, extends through the structure of the investment and into the deal management process, and ends as the venture capitalist positions the company for an exit to a situation where it can continue to grow. In the paper that follows, we explore the ways in which each step creates value and the best practices that can be employed.

Value creation plays an important role in every venture capital investment in all regions. With the youth of the industry in Latin America and the Caribbean (LAC), the issue of value addition is particularly critical. Historically, VC industry data for the region has been sparse and was only separated from private equity (PE) totals recently. The Latin American Private Equity and Venture Capital Association (LAVCA) reports that LAC's VC investment has grown by 574% between 2010, when it reached its nadir of $63 million over the past six years, and 2013 when it reached $425 million. Over this period, investor interest has expanded beyond Brazil to Chile, Colombia, and Mexico. As of 2014, the Emerging Market Private Equity Association's (EMPEA's) survey of limited partner (LP) interest rated the region apart from Brazil as the best place for future investment, up from third place in 2013, and Brazil as fifth, up from sixth the year before.[1] The most substantial concern cited by the respondents was the difficulty of finding experienced fund managers who are familiar with creating value in portfolio companies.[2]

Methodology

To support the education of its own venture capitalists and collect a series of best practices, the Multilateral Investment Fund (MIF), part of the Inter-American Development Bank (IDB) Private Sector Group, commissioned Bella Research Group to

[1] EMPEA, "Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets 2014," (Washington DC: EMPEA): pp. 8.
[2] EMPEA, "Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets 2014," (Washington DC: EMPEA): pp. 10.

compile this paper on value creation in VC with special attention to LAC. Drawing on academic literature, industry statistics, the MIF's own experience and interviews with six LAC fund managers, and placing this material in the context of their combined 56 years of experience in studying the VC industry, the authors describe the challenges that fund managers face in this task and suggest nine best practices. These, we hope, will be especially helpful in LAC where the VC industry and the infrastructure that supports it are still relatively young and important as these economies develop.

Part of the challenge with VC lies in the vocabulary. "Firms" can mean the VC firm or the company in which it invests; "investor" can refer to the LP or the venture capitalist (sometimes also called a general partner, or GP). For simplicity, we use the following conventions in this paper:

- "VC firm" is the firm that has raised the fund that is investing in the company.
- "Fund managers" or "venture capitalists" are the individuals that manage the firm/fund.
- "LPs" invest in the fund that the firm raised.
- "Portfolio company" or "company" refers to the company in which the VC firm has invested.
- "Private equity" or PE refers to later stage investments.
- "VC/PE" refers to the entire industry.

The Challenges that LAC Fund Managers Face

The VC industry in LAC is maturing along with the region's economies. Among the challenges are less developed business regulations and institutions; unreliable legal frameworks and uncertain contract enforcement; macroeconomic volatility; weak intellectual property rights; uncertain protection for the rights of minority shareholders; and high levels of perceived corruption. These challenges are exacerbated by what some describe as the region's cultural aversion to risk and failure. Unlike the attitude of Thomas A. Edison, inventor of the light bulb, who reportedly said, "I have not failed. I have found 10,000 ways that won't work," and Silicon Valley, where failure is seen as an important part of the learning process,[3] an unwillingness to risk failure restrains LAC's innovative and entrepreneurial culture.

Furthermore, entrepreneurs in the LAC region are less familiar with best practices in business, such as reaching beyond family and friends for investors in their companies, and most are new to the expectations of active, equity-owning investors. Finally, these situations vary greatly between countries. Thus, what works in one LAC country may not succeed in another, forcing fund managers to be particularly flexible and creative to add value in their portfolio companies.

[3] As Sequoia's Don Valentine said, "The sadder- but-wiser and humbled 35- to 40-year-old will take a lot of risk out of the situation…"[3] Cheryll Aimee Barron, "Silicon Valley Phoenixes," *Fortune*, November 23, 1987, in Josh Lerner, Ann Leamon, and Felda Hardymon, *Venture Capital, Private Equity, and the Financing of Entrepreneurship* (NY, NY: J. Wiley, 2011).

Value creation occurs along the entire cycle of a venture capitalist's involvement with a company: due diligence, deal structuring, deal management, and exit. Below, we describe each stage and its attendant challenges.

- Due diligence and deal sourcing: Finding a promising deal invariably confronts a venture capitalist with significant challenges due to "information asymmetry"—the fact that the entrepreneur knows more about the company and its prospects than does an outsider. In LAC, nascent information systems complicate the task of finding information on a potential entrepreneur-investee and on the company. Similarly, many emerging market entrepreneurs have less developed business skills and understanding than one finds in developed markets, further hampering the fund manager's ability to assess the company's prospects. Finally, recovering from a bad judgment may also be difficult, because the depth of management talent rarely allows easy replacement of executives and weak anti-defamation laws combined with the unfamiliarity with VC can leave venture capitalists exposed to law suits and other negative press.

- Deal structuring: The deal should be structured to align the interests of all parties in its success. The terms of the agreement—whether milestones for further financing or triggers for increased ownership—must be carefully thought out to ensure that the proper strategies are adopted. For instance, triggering increased ownership based on revenues will create a different income statement and set of incentives than would basing it on profits. Similarly the control rights embedded in a deal's structure and securities represent a critical point of leverage for the venture capitalists. In many emerging markets (not just LAC), weak laws protecting minority shareholder rights can hamper the fund managers when they try to take unpopular steps to turn around a struggling investment. Lack of legal support for securities such as preferred stock can force venture capitalists to acquire majority positions in their companies, which restricts the pool of possible investments—not only are fewer entrepreneurs willing to sell a majority position in their companies, but a fund of a given size can afford a smaller number of large positions.

- Deal management: Encouraging management teams to implement best practices and take corrective action is difficult at the best of times. Ensuring that portfolio companies gather the skills and expertise they need—occasionally by replacing an executive—is also daunting. Moreover, changes in the market or the broader environment can force rapid revision of plans, a situation not unique to young companies in emerging markets! Another challenge in deal management in LAC involves the development of trust between the entrepreneur and investors. In developed markets, management teams expect to work closely with their equity-holding investors, because much of the reason for taking VC is the advice that accompanies the financing. When business understanding is less developed and the board's value less understood, establishing this basic relationship, even if it is enshrined in deal documents, can be much more difficult.

- Exit: Ensuring that the company can continue to grow is the final stage of value creation for a venture capitalist. In LAC, the option of an initial public offering (IPO) is fairly constrained, but many investee companies are exited through trade sales, usually acquisitions by larger companies. A few of the more dynamic companies have exited via IPO on other global stock markets. For instance, Globant, an Argentine software company, went public on the New York Stock Exchange in July 2014. Globant was the first LAC software company to do so and had taken 11 years to mature to that point.[4] To achieve this final step in value creation, the venture capitalist must have aligned incentives properly from the start. Proper incentives for the Chief Financial Officer (CFO), who will likely lose his position, are critical to engage his commitment and support for the enterprise, which will create vast amounts of work for his department.

The Best Practices

In the course of writing this paper, we identified nine practices for creating value in portfolio companies. Some of them apply to the internal operations of the VC firm, while others address methods through which the fund managers interact with the portfolio companies. A comprehensive best practice is the one exhibited by the management companies that participated in this project: Sharing within the firm and throughout the industry the lessons learned in venture capital investments in LAC. The other best practices are listed below:

<u>Internal Best Practices</u>

1. *Define Your Playing Field.* VC firms should approach investments with a clear understanding of their own unique investment philosophy. They should have detailed knowledge of the regions, industries, and company stages in which they invest. This focus should be informed by their internal strengths and expertise. The fund managers should not be tempted into "hot" sectors, where they lack expertise. When fund managers stray into trendy sectors, the risk is far greater than the reward: success is expected, while failure brings the firm's entire decision-making process into question.

2. *Establish Roles and Processes.* The investment teams should clearly delineate internal roles and responsibilities. Each deal should be assigned a "champion" to spearhead it from due diligence to exit, ensuring consistency and accountability throughout the investment. Fund managers should regularly socialize deals through every stage of the investment. Communicating frequently and sharing information on one's investments with colleagues accesses "the wisdom of the partnership" and reduces the chances that the fund managers will overlook important factors or repeat past mistakes.

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[4] Shane Romig, "Argentina's Globant Shares Jump After NYSE IPO," Wall Street Journal, July 18, 2014, http://online.wsj.com/articles/argentinas-globant-shares-jump-after-nyse-ipo-1405717580, accessed September 10, 2014.

3. *Do Not Fall in Love with the Deal, the Entrepreneur, or the Sector*. Due diligence should be exhaustive, regardless of whether someone in the team knows the entrepreneur, or he/she comes highly recommended by someone close to the management team, or has had previous successes. It pays off to be highly skeptical in the beginning.

4. *Enter with Your Eyes on the Exit.* VC firms must consider possible exit routes from the initial due diligence until a successful exit is executed. Firms should consider exit routes when negotiating deals, and take steps during the life of investments to make portfolio companies more attractive and suitable for exit opportunities.

5. *Create a Strong Team that will stay throughout the fund's life*. While there is no assurance that the whole team will stay throughout the fund's life, creating strong alignment and incentives, such as the general partner's contribution to the fund and vesting of the carried interest, ensures better deal performance. A fund that suffers staff departures at any level loses important institutional memory and imperils the confidence of limited partners and the relationships with entrepreneurs.

6. *Have an Active, Informed, and Engaged Investment Committee.* This practice applies to all partners in a fund, as it is easy to avoid the "hard questions" of a deal in the interests of good relationships. In LAC the industry is young enough that another dynamic can complicate relations among the firm's decision-makers: the addition of independent members to the Investment Committee (IC) who add value through their sector or operating expertise. The fund managers must determine the best way to align these independent members and keep them interested throughout the fund's life, and to encourage them to be active, value-adding members of the team. Another complication can be introduced when LPs serve on the IC and put their goals ahead of those of the fund as a whole.[5] The need for active engagement also applies to the LP Advisory Committee (LPAC) if a fund manager chooses to have one.

<u>External Best Practices</u>

7. *Know Thy Entrepreneur.* Fund managers should thoroughly vet entrepreneurs before making investments. It is important to have a strong knowledge of their strengths and weaknesses. It is especially important to investigate their character. Fund managers must be confident that their entrepreneurs will exhibit good partnership behavior. Testing the dynamics of the company at the senior and mid-management often can reveal many simmering problems, such as management divided in two camps of allegiance and others.

[5] For more on this topic, please see Ann Leamon, Josh Lerner, and Susana Garcia-Robles, "The Evolving Relationship Between LPs & GPs," *MIF Knowledge Product*, September 5, 2012.

8. *Structure Deals that Protect Your Position.* Fund managers should negotiate deals that allow them to influence the success of the company. Investments should be tranched and linked to milestones. Fund managers should use preferred stock whenever possible, although some underdeveloped regions like Central America and the Caribbean may benefit from using quasi-equity[6] as an entry point to the relationship with the entrepreneur, until it becomes clear the business presents a good opportunity for partnership. VC firms should legally protect their control rights when negotiating deals, considering the legal framework of the countries in which portfolio companies are domiciled.

9. *Guard Your Reputation.* Fund managers must consider the consequences of their actions on their firm's reputation. The youth of the VC industry in LAC lends itself to misinterpretation by outsiders. Fund managers should strive to thoroughly explain the nature of VC investments to entrepreneurs before finalizing deals, maintain amicable relationships with portfolio company management teams, and always act responsibly to protect the reputations of their firms and themselves. The more protective clauses the fund managers include in their contracts, the more careful they must be to ensure that the entrepreneur understands the true nature and implications of the agreement. Non--defamation clauses are also recommended to protect the fund managers in case stringent measures are required to seize control of the company.

Conclusions

The unique situation of LAC VC fund managers requires an adjusted approach to value creation, one focused on the particular challenges in the region. The above best practices provide a framework they can use to aid in this process. Fund managers can adapt the framework to meet the particular needs of distinct investments. As the regional VC/PE landscape changes moving forward, LAC VC firms should regularly assess their experiences and continuously generate best practices that respond to their circumstances. Sharing these lessons through their firms and coming together to share lessons across the LAC VC industry will afford fund managers the best chances of success and help to develop the industry throughout the region.

[6] Quasi-equity refers to securities that act like debt but allow the investor to share in the company's proceeds; often a percentage of revenues or profits, in addition to standard interest and principal repayments. These arrangements go by a number of names, including royalty models, subordinated debt, mezzanine debt, and debt with an equity kicker.

Background of the Report

The Multilateral Investment Fund (MIF) is part of the Inter-American Development Bank (IDB) Private Sector Group. Since its founding in 1993, the MIF has played a distinct role within the IDB, pursuing innovative ways to build economic opportunity and decrease poverty.

The MIF has been investing in LAC VC for almost 20 years. Over that period, it has played an important role in developing the overall VC ecosystem by supporting regulatory changes, training policy makers, and by investing in fund managers. One of the organization's major goals involves training fund managers and sharing best practices across the region, thereby increasing the skill levels of practitioners and the results for investors. Most significantly, a VC environment operating with global best practices will boost economic growth, innovation, and job creation in the LAC region. With this goal, Susana Garcia-Robles of the MIF commissioned Bella Research Group to prepare a paper on best practices in adding value to VC investments in LAC.

A number of LAC VC fund managers shared their experiences and insights with Bella Research Group to help generate a list of best practices for venture capitalists throughout the region. The generous donation of their time and expertise added to the content and quality of the paper. These individuals and their firms are listed below. Bella Research Group is grateful to each of them for their contributions to this work.

- Dra. Alicia Caballero – Fondo ILEX
- Michael Chu – IGNIA
- Daniel Izzo – Vox Capital
- Jorge Karadima – Sembrador
- Francisco Mira A. – Promotora
- Jose Ulate – Emerge
- Juan Andrés Vásquez G. – Promotora
- Alex von der Goltz – CoreCo Private Equity

An Introduction to VC in LAC

The Latin American and Caribbean (LAC) venture capital and private equity (VC/PE) industry is in an exciting period of development. Traditionally, "private equity" broadly includes the full range of non-public stock, ranging from small investments in seed-stage businesses to large multibillion dollar leveraged buyouts. To avoid confusion, however, this paper will use VC/PE to refer to the industry as a whole, VC for seed- and early-stage investments, and PE for later stage transactions.

In 2014, limited partners (LPs) ranked LAC apart from Brazil as the most attractive emerging market destination for VC/PE investment, illustrating the regional industry's growing strength.[7] The Latin American Private Equity and Venture Capital Association's (LAVCA) Scorecards further reveal this regional development; among the 10 countries included in both the original (2006) and most recent rankings updated in 2014, the average VC/PE business environment score has increased from 49.9 to 57.8.[8]

Over the past five years, total VC/PE industry fundraising in LAC has fluctuated greatly. As shown in Figure 1, annual fundraising for VC/PE reached a high of $10.3 billion in 2011, while 2013's total of $5.5 billion marked the smallest amount of capital raised since 2009.[9] The 2013 fundraising slump reflected a drop in capital allocated to funds focused on Brazil-only, which historically dominated LAC's VC/PE activity. Excluding Brazil, allocations to the VC/PE industry in the rest of the region actually increased from just under $2 billion in 2012 to over $3.1 billion in 2013.[10]

Looking at investments, VC/PE industry fund managers deployed over $8.9 billion in the region in 2013, the highest amount of capital invested since the Great Recession. The $6 billion invested in Brazil in 2013 accounted for 68% of LAC's total investments by value, and Brazilian deals counted for 147 of the 233 deals reported by LAVCA that year.[11] The concentration of VC/PE activity in Brazil suggests opportunities for the industry to grow throughout the rest of the region.

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[7] EMPEA, "Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets 2014," (Washington DC: EMPEA): pp. 8.

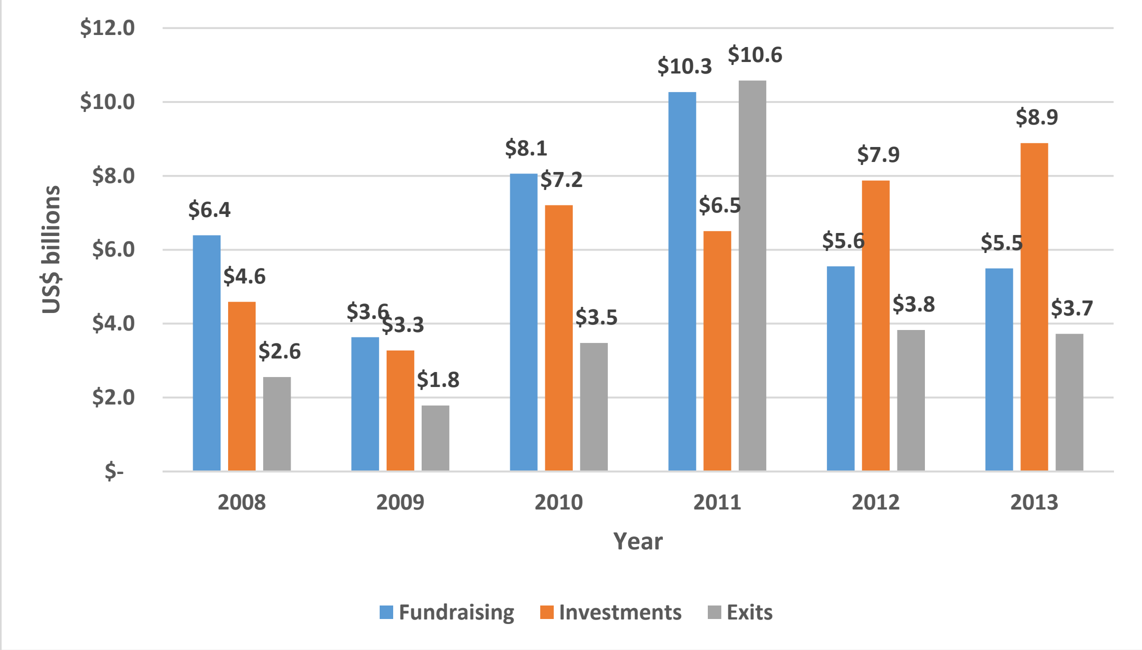
[8] Latin American Private Equity and Venture Capital Association, *2013 LAVCA Scorecard on the Private Equity and Venture Capital Environment in Latin America, 2014 Update,* May 2014.
Latin American Venture Capital Association, *2006 Scorecard on the Private Equity and Venture Capital Environment in Latin America and the Caribbean*, EIU, LAVCA, MIF, 2006.

[9] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital,* LAVCA, 2014.

[10] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital*, LAVCA, 2014.

[11] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital,* LAVCA, 2014.

Figure 1: Annual LAC VC/PE Fundraising, Investments, and Exits[12]

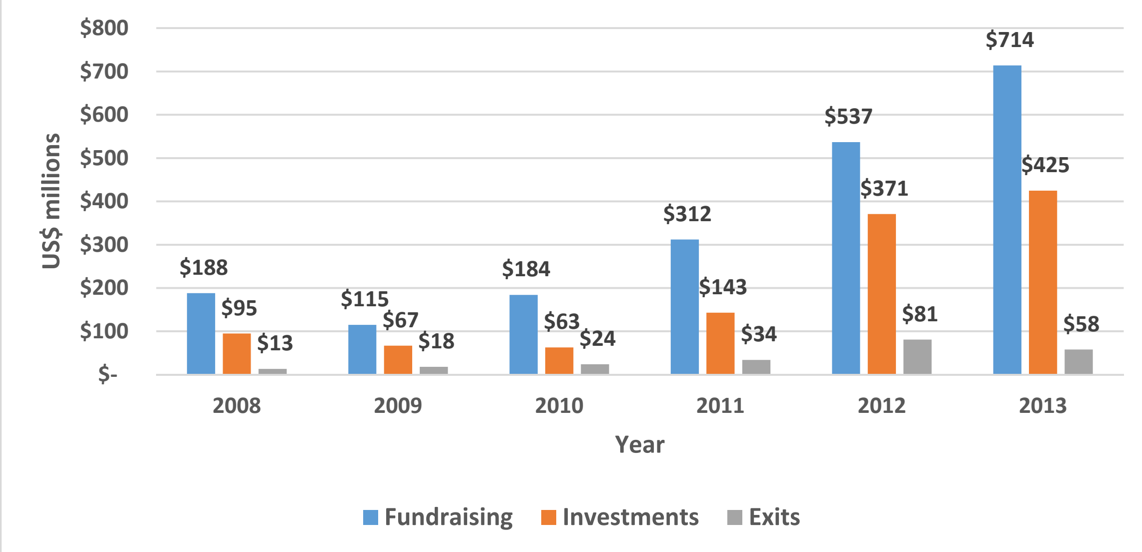


Source: *2014 LAVCA VC Data*

The VC/PE industry in LAC has historically focused on larger and later-stage deals. VC investments, which focus on early stage companies, accounted for 3.0% of total VC/PE capital invested in LAC from 2008 to 2013.[13] This proportion is much lower than that of emerging markets overall; according to Emerging Market Private Equity Association (EMPEA) data, VC has accounted for over 14% of total emerging market VC/PE capital invested between 2009 and 2013.[14] While these data indicate that the VC industry has room to grow in LAC, recent trends show that this process is well underway. As shown in Figure 2 below, LAC VC investments have increased greatly since 2008, climbing from a six-year low of $63 million in 2010 to a high of $425 million in 2013.[15] Similarly, fundraising for early stage funds has been steadily rising; in 2009 $115 million was committed to VC funds, while investors committed $714 million to such vehicles in 2013.[16]

[12] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital*, LAVCA, 2014.
[13] Latin American Private Equity and Venture Capital Association, *2014 LAVCA VC Data*, LAVCA, 2014. And Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital*, LAVCA, 2014.
[14] EMPEA, *Latin America Data Insight (Q1 2014)*, EMPEA, May 7, 2014.
[15] Latin American Private Equity and Venture Capital Association, *2014 LAVCA VC Data*, LAVCA, 2014.
[16] Latin American Private Equity and Venture Capital Association, *2014 LAVCA VC Data*, LAVCA, 2014.

Figure 2: Annual LAC VC Fundraising, Investments, and Exits[17]



Source: *2014 LAVCA VC Data*

The growth of the VC/PE industry in LAC is noteworthy due to the benefits it provides to society. VC firms provide risk capital that supports start-ups and thus an ecosystem that encourages innovation and entrepreneurship, and allows established businesses to grow and expand their operations. Research has indicated that VC and PE investment both improve companies' operations, management practices, and productivity.

LAC countries—along with other emerging markets—can benefit from the positive effects of VC/PE, particularly VC. The biggest challenge cited by LAC firms in the World Bank's *Enterprise Surveys* was access to finance.[18] Limited access to finance is the obstacle that most directly constrains growth[19], and disproportionately affects smaller firms.[20] VC targets these small businesses and entrepreneurs that contribute significantly to innovation and job growth. Sam Kortum and Josh Lerner's article from 2000 compared the innovative impact of VC financing relative to corporate R&D expenditures in the U.S. between 1965 and 1992. They found that a dollar of VC financing appeared to generate three to four times more innovation than a dollar of corporate R&D spending.[21] By funding and supporting these promising companies, VC provides the capital and advice that supports their growth into larger operations that can increase employment and drive economic development.

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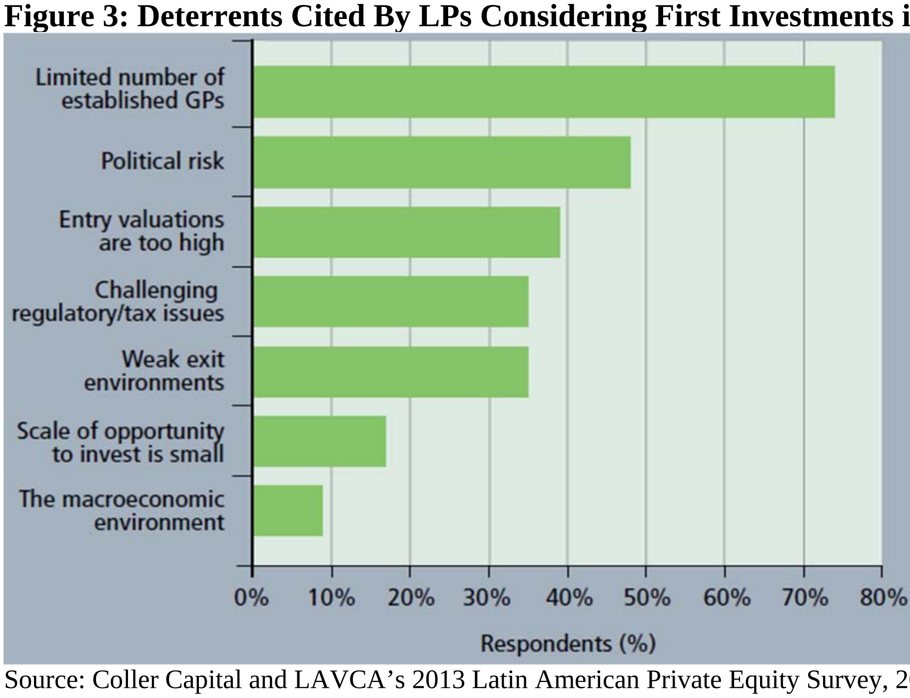
[17] Latin American Private Equity and Venture Capital Association, *2014 LAVCA VC Data*, LAVCA, 2014.
[18] The World Bank Group, "Enterprise Surveys," http://www.enterprisesurveys.org/, accessed August 5, 2014.
[19] Meghana Ayyagari, Asli Demirguc-Kunt, and Vojislav Maksimovic, "How Important Are Financing Constraints? The Role of Finance in the Business Environment," *The World Bank Economic Review*, Vol. 22, No. 3, 483-516.
[20] Veselin Kuntchev, Rita Ramalho, Jorge Rodríguez-Meza, Judy S. Yang, "What Have We Learned from the Enterprise Surveys Regarding Access to Credit by SMEs?" The World Bank Enterprise Analysis Unit, May 2014.
[21] Sam Kortum and Josh Lerner, "Assessing the Contribution of Venture Capital to Innovation," *Rand Journal of Economics*, vol. 13, no. 4, Winter 2000, 674-692.

LAC's current VC environment faces a challenging dynamic: new fund managers are emerging, yet LPs are hesitant to invest in them. Few investors, including DFIs, have shown the appetite exhibited by the Multilateral Investment Fund in supporting first-time fund managers. There is only a small number of experienced fund managers. GP Investimentos, a Brazilian PE firm, has invested over $5 billion in 53 portfolio companies since its inception in 1993. CRP, was one of the very first pioneers in the industry back in the 1980s, and the Stratus Group and DGF Investimentos each have approximately 15 years of experience. While these three firms are based in Brazil, they have played important roles in growing the VC/PE industry in the entire region. First, their strong results demonstrated the opportunities available throughout LAC and thus attracted LPs to their own funds and other firms to the region. Second, investment professionals who left these firms often established their own, building the industry. Finally, governments in other countries, seeing the impact of these firms in Brazil, sought to attract VC/PE investment to their own nations and started to enact the necessary legislation and to introduce programs that encouraged and rewarded entrepreneurship.

The growing number of new fund managers, however, is a concern to LPs – in fact, a 2013 report noted that LPs considering their first investments in LAC over the next five years rated the limited experience of the fund manager (also known as general partner, or GP) community as the #1 deterrent to investing in the region, as shown in Figure 3 below.[22] EMPEA's 2014 *Global Limited Partners Survey* similarly found that LPs' chief concern in LAC was the limited number of established fund managers.[23]

Figure 3: Deterrents Cited By LPs Considering First Investments in LAC[24]



Source: Coller Capital and LAVCA's 2013 Latin American Private Equity Survey, 2014 update.

[22] Coller Capital, "Latin American Private Equity Survey," Coller Capital and LAVCA, 2013: pp. 5.
[23] [23] EMPEA, "Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets 2014," (Washington DC: EMPEA): pp. 10.
[24] Coller Capital, "Latin American Private Equity Survey," Coller Capital and LAVCA, 2013: p. 5.

Thus, the region’s VC fund managers must show that they can create value. As an emerging market, LAC naturally presents unique challenges for fund managers and their portfolio companies: less developed regulatory institutions, unpredictable contract enforcement, weak intellectual property and minority shareholder rights, high levels of perceived corruption, and a general unfamiliarity among entrepreneurs of the role of engaged, equity owning investors. By using best practices to address these specific challenges, venture capitalists can create value in their companies and attract LP investment.

I. A Literature Review of Value Addition Through PE and VC

Private equity, most broadly defined, refers to any company with securities that do not trade on a public market. Thus, such companies range from raw start-ups of one or two people to large operations that are undergoing operational turnarounds. The industry has grown greatly over its history of less than 70 years. Today, most governments recognize that a thriving VC/PE environment is critical to creating and maintaining a healthy, competitive economy. VC is of particular interest because it supports the small and medium enterprises (SMEs) that are most commonly associated with job creation and innovation within an economy. SMEs are even more significant in LAC, as the number of large companies in the region is not sufficient to support a vibrant PE industry. VC, then, plays an important role in supporting the establishment and growth of younger, growing enterprises.

VC fills a major financing gap for SMEs and entrepreneurs with promising ideas. In the World Bank's *Enterprise Surveys*, which collected data from over 130,000 firms in 135 countries, the biggest obstacle cited by firms in LAC, specifically, was access to finance.[25] A 2008 study published in the *World Bank Economic Review* sought to evaluate the impact of purported constraints cited by firms across the world and found empirical support for access to finance as the constraint that most directly affects firm growth.[26] A 2014 study that looked more closely at the relationship between firm size and relative access to finance found that SMEs in every region experienced higher levels of credit constraint than larger firms.[27] These results point to the fact that VC, which targets smaller firms, provides LAC businesses with critical capital that facilitates their growth and spurs increased economic opportunity. In addition, because venture capitalists take an ownership position in the company, they provide active guidance and advice to refine strategy and improve business practices.

In the U.S., VC funding has contributed to the development of innovative companies ranging from PayPal and FedEx to Hewlett Packard and Google, and the creation of numerous jobs. The most recent *Venture Impact* study released by the U.S.-based National Venture Capital Association found that VC-backed companies generate revenues equal to 21% of U.S. GDP and are responsible for 11% of U.S. jobs, even though VC investments amount to less than 0.2% of U.S. GDP.[28] VC also spurs innovation. Kortum and Lerner's article, mentioned before, examined 20 industries between 1965 and 1992, and suggested that VC financing accounted for 8% of total U.S.

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[25] The World Bank Group, "Enterprise Surveys," http://www.enterprisesurveys.org/, accessed August 5, 2014.

[26] Meghana Ayyagari, Asli Demirguc-Kunt, and Vojislav Maksimovic, "How Important Are Financing Constraints? The Role of Finance in the Business Environment," *The World Bank Economic Review*, Vol. 22, No. 3, 483-516.

[27] Veselin Kuntchev, Rita Ramalho, Jorge Rodríguez-Meza, Judy S. Yang, "What Have We Learned from the Enterprise Surveys Regarding Access to Credit by SMEs?" The World Bank Enterprise Analysis Unit, May 2014.

[28] National Venture Capital Association and IHS/Global Insight, *Venture Impact*, edition 6.0, (NVCA, 2011).

industrial innovation from 1983-1992, and likely accounted for 14% of industrial innovation by 1998.[29]

On the company level, studies have shown that VC investment brings a number of benefits, including better governance, management practices, productivity, and overall operations. Addressing the first item, upon investing in a company, venture capitalists quickly implement best practices in governance. A 2012 study by Yael V. Hochberg examined the governance practices of over 2,800 newly public firms between 1983 and 1994.[30] Evaluating the quality of firm governance on a number of dimensions, the study found that at the time of their IPOs, VC-backed companies displayed significantly better governance practices (transparency, shareholder protection, and board independence) than their non-VC-backed counterparts. A 2003 study by Steven Kaplan and Per Stromberg corroborates VC's strong impact on portfolio company governance, noting the extensive monitoring and advisory systems implemented in companies upon receiving VC financing.[31]

Furthermore, VC-backed companies out-perform their non-venture-backed peers. A study by Manju Puri and Rebecca Zarutskie, which compared the performance of venture-backed and non-venture backed companies founded in the U.S. between 1981 and 2005, found that the venture-backed companies were larger than the comparisons in terms of both employment and sales, and that the average growth rate of the venture-backed firms was higher.[32]

Additionally, a 2012 study that examined the effects of PE investment on later stage Indian firms found that the governance practices of PE-funded firms were superior to those of non-PE-funded firms.[33] As PE investments in all stages generally adopt similar governance structures, the study indicates that the model of both VC and PE is associated with better governance practices even within countries where these practices are still evolving. A study by Paul Gompers, Joy Ishii, and Andrew Metrick describes the positive effects of these governance systems.[34] The paper examined the governance structures of about 1,500 firms during the 1990s and found that robust governance practices correlated strongly with better overall performance, including higher returns, higher valuations, and better operating performance. Investments in companies ranked in the top decile for strong minority governance rights outperformed those in the lowest decile by over 9%

[29] Sam Kortum and Josh Lerner, "Assessing the Contribution of Venture Capital to Innovation," *Rand Journal of Economics*, vol. 13, no. 4, Winter 2000, 674-692.
[30] Yael V. Hochberg, "Venture Capital and Corporate Governance in the Newly Public Firm," *Review of Finance*, vol. 16, 2012, 429-480.
[31] Steven N. Kaplan and Per Stromberg, "Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts," *The Review of Economic Studies*, vol. 70, no. 2, April 2003, 281-315.
[32] Manju Puri and Rebecca Zarutskie, "On the Life Cycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," *The Journal of Finance*, 2012, 67: 2247–2293.
[33] Rafiq Dossani, "Private equity and corporate governance in India," *Journal of Asia Business Studies*, vol. 6, no. 2, 2012, 223-238.
[34] Paul Gompers, Joy Ishii, Andrew Metrick, "Corporate Governance and Equity Prices*,"* *The Quarterly Journal of Economics*, Vol. 118, No. 1 (Feb., 2003): 107-155.

per year on average, providing quantitative support for the value conveyed through improved governance practices.

As part of improving governance, PE positively affects management practices. One empirical study by Nicholas Bloom et al. examined the management practices of 4,000 medium-sized manufacturing firms from around the world.[35] The results indicated that PE-backed firms exhibited the best management practices overall, significantly higher than many other forms of ownership including by government, family, and dispersed public shareholders. These PE-owned enterprises demonstrated especially strong operations and people management skills, including factors like lean manufacturing, continuous improvement, and effective monitoring, hiring, firing, compensation, and promotion practices. The study went on to confirm the validity of these factors as "best practices" in management by evaluating the performance of the companies in the study. It found that the measures of management utilized in the study were significantly associated with better firm performance across multiple dimensions.

PE-backed firms also exhibit greater productivity than their non-PE-backed counterparts. A recent study by Davis et al. tracked 3,200 U.S. firms that underwent PE buyouts from 1980 to 2005, comparing them to controls defined by industry, size, age, and prior growth.[36] Examining productivity both before and after acquisition, the study found that total factor productivity markedly improved after the PE buyouts. The productivity gains were driven by more efficient resource allocation, as firms quickly exited less productive operations and entered more productive ones.

Finally, PE-ownership—like the VC ownership discussed above—also appears to improve the overall operations of portfolio companies, as shown in a 2014 paper by Shai Bernstein and Andrew Sheen.[37] The study compiled data on every restaurant inspection in Florida between 2002 and 2012. Over that period, PE buyout firms acquired 94 restaurant chains, accounting for approximately 3,700 individual restaurants of the 50,000 in operation in Florida. The study found that PE-ownership of restaurants significantly reduced the number of "critical" health code violations. Store-level operational practices improved after a buyout; restaurants became cleaner, safer, and better maintained. Additionally, these effects were greater in the company-owned stores (over which the PE firms had greater influence) than among franchised locations, indicating that the operational improvements were driven by the PE firms' involvement rather than exogenous factors. It is likely that early stage VC investments likewise improve portfolio company operations, as they employ methods similar to those of their later stage counterparts.

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[35] Nicholas Bloom, Raffaella Sadun, and John Van Reenen, "Do Private equity-owned Firms have Better Management Practices?" In A. Gurung and J. Lerner, editors, *Globalization of Alternative Investments Working Papers Volume 1: Global Economic Impact of Private Equity 2009*, New York, World Economic Forum USA, www.weforum.org/usa, 3-22.
[36] Steven J. Davis, John Haltiwanger, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity, Jobs, and productivity," *Globalization of Alternative Investments: Working Papers Vol. 2"* (NY, NY: World Economic Forum USA, 2009); 27-38.
[37] Shai Bernstein and Albert Sheen, "The Operational Consequences of Private Equity Buyouts: Evidence from the Restaurant Industry," Available at SSRN 2336672, 2013, March 2014.

The studies described above bolster the argument that VC and PE create value in portfolio companies, and contribute to wider economic value within a society. While there is widespread research to indicate that VC and PE investment has positive impacts on portfolio companies, we are only starting to develop a clear understanding of the way this is done operationally. The rest of this paper looks closely at the specific ways in which fund managers generate value, paying particular attention to the situation of VC investors in LAC. We will present our knowledge to date and augment it with the experiences of LAC fund managers in the field, examining the challenges they face and proposing specific best practices that can help to address those obstacles.

II. Value Creation Using VC in LAC

VC—the provision of capital to young companies in exchange for a share of equity—has a pronounced role to play in LAC. Even in developed nations, venture capitalists offer entrepreneurs and young companies crucial business expertise in addition to financing, the potent combination of which transforms these businesses. In emerging markets, where best business practices are less well known, the role of venture capitalists in helping their portfolio companies is all the more significant. As venture-backed entrepreneurs succeed, they can become role models within their economies, raising the level of business knowledge and skills in the region. Their example, and the example of the VC industry at large, can help to combat regional risk aversion and the stigmatization of failure, and contribute to fostering a culture of innovation and entrepreneurship throughout the region.

VC firms cannot generate returns for their LPs, sustain themselves, or benefit society unless they create value in their companies. The value creation process occurs throughout the venture capital investment cycle. We define this cycle as having four distinct stages: Deal Sourcing and Due Diligence; Deal Structuring; Deal Management; and Deal Exiting. We will therefore consider each step of the VC value creation process to understand the many ways in which VC firms improve their portfolio companies.

A. Deal Sourcing and Due Diligence

For venture capitalists, the process of value creation in a company begins with deal sourcing and due diligence. Deal sourcing is the practice through which fund managers find investment opportunities. During due diligence, they gather data on the potential investments and decide whether or not to fund them. This step creates value by helping ensure that only the most promising companies receive financing, and by producing information that aids in assessing the opportunity and structuring the future value creation plan.

Deal sourcing, the ability to judge a company's potential with a degree of accuracy, is a prime skill for venture capitalists. In LAC, with limited access to early-stage financing, ensuring that available capital reaches the most promising companies is crucial for returns both to the LPs and to the economy overall. Proper due diligence, the companion to deal sourcing, gathers information on the company's current situation and its future. A detailed understanding of the company's strengths and deficiencies informs the venture capitalists' choice of a growth strategy, sheds light on key metrics to be evaluated during the life of the investment, and helps fund managers set the milestones that will trigger additional financing. The thorough review of the company can greatly inform entrepreneurs and management teams, especially in regions where strategic business planning is less common. Even companies that do not ultimately receive financing can gather useful lessons from the process, which may help them improve their models and perhaps receive financing in the future.

The specific aspects of a venture capitalist's due diligence checklist could make up an entire paper themselves. A 1984 study by Tyzoon Tyebjee and Albert Bruno on the topic is still applicable today.[38] Based on data on 41 deals provided by 90 U.S. venture capitalists (a substantial proportion of the industry at the time), they determined that deals were assessed along five dimensions:

- Market Attractiveness (size, growth, customers);
- Product Differentiation (uniqueness, patents, technical edge, profit margin);
- Managerial Capabilities (experience in marketing, management finance, and the entrepreneur's references);
- Environmental Threat Resistance (technology life cycle, barriers to entry, robustness against business cycles, downside risk protection); and
- Exit Options (possibilities for a merger, acquisition, or IPO).

In emerging markets such as LAC, the venture capitalists might wish to add matters such as legal structure and conformity to the country's legal codes, and the degree to which changes in government policies would affect the company's prospects. For instance, what might happen if the government reneged on its grant of certain lucrative flight paths to a start-up airline, or stopped subsidies provided to the housing and agribusiness sectors, affecting a fund's investments in those sectors. While such changes can and do occur, the fund managers must consider how they and the management team could anticipate and react to them.

Before embarking on the process of deal sourcing and due diligence, fund managers must clearly understand their firm's identity and value creation expertise. Defining the investments that a VC firm will and will not make begins when the firm raises capital for a new fund. While fundraising, firms must articulate their realms of investment interest. In what countries/regions will they invest? How large will the investments be? What stage of company development will they target? In what industries? How will they add value? Some funds specifically target family-owned businesses that are experiencing generational succession. Others target state-owned enterprises that are going private. Still others invest in corporate spin-outs.

VC firms can be more successful by precisely defining the areas in which they will invest – the same areas in which the fund managers have particular expertise. A study by Paul Gompers, Anna Kovner, and Josh Lerner supports this statement.[39] The authors examined VC investments in over 11,000 companies and found that specialist VC firms with specialized investors (that is, a life science-focused firm staffed with life-science experts) performed better than did either generalist firms with specialist partners (firms investing in information technology and life science with partners that had expertise in either sector) or generalist firms with generalist partners. The generalist firms with specialist partners did outperform the generalist firms with generalist partners, but not their

[38] Tyzoon Tyebjee and Albert Bruno, "A Model of Venture Capital Investment Activity," *Management Science*, 30, n. 6, (1984): 1051-66.
[39] Paul Gompers, Anna Kovner, and Josh Lerner, "Specialization and Success: Evidence from Venture Capital, 2009.

specialist competitors. The study indicates that VC firms benefit from assessing their internal areas of expertise and pursuing the investments for which they are best suited.

This dynamic appears to be especially true of VC in LAC, as the nuances of local regulations, legal enforcement, and industry dynamics vary greatly between countries. Many LAC fund managers have identified the importance of local expertise in facilitating successful value creation in the region. In some emerging markets, this local expertise becomes sufficient specialization given the small size of the possible investment pool.

With a clear idea of what companies fit their firms' expertise, fund managers can seek out investment opportunities. Particularly reputable firms may attract deals as entrepreneurs actively approach these funds seeking equity investments. More often, fund managers must develop methods of seeking out promising targets for venture investment. In many cases, venture capitalists create industry "road maps" that describe the current direction and likely future of particular industries in which they wish to invest. They then seek promising companies that are well-positioned for growth given these industry predictions, often through conferences, trade shows, industry journals, or personal networks. This latter tool is particularly vital in LAC where more formal channels of deal flow may be less established. A venture capitalist's personal and professional connections—friends, bankers, stockbrokers, service providers, and business development officers—can be key sources for leads on potential investment opportunities.

In some nascent VC environments, however, the choice of company rests entirely on quality of the management team. Thus, in some markets, a VC firm's portfolio may encompass a range of industries and be linked solely through their shared geography and need for business guidance. Fund managers must be aware of the gradual evolution of their countries and the need to specialize as the market matures.

Conflicts of interest are an issue that should be identified and addressed during deal sourcing and due diligence. Many LAC fund managers have noted that the small, interlinked business communities in the region can produce conflicts of interest. Venture capitalists may have close historical or family ties to the management teams of possible investments or to companies with whom portfolio companies may compete. A venture capitalist or her family may be personally invested or planning to invest in a company of interest to the VC firm. Since VC firms have a fiduciary duty to their LPs, it is important to identify any situation in which an employee or affiliate of the VC firm may seem to benefit unduly from an investment, or have concerns that could conflict with the interests of the fund's LPs. Even the mere *perception* of such conflicts can damage a VC firm's reputation. Thus, VC firms must establish clear guidelines and procedures to help partners identify and navigate conflicts as they arise.

On a VC firm and fund level, partners and employees should disclose potential conflicts to LPs while fundraising. For instance, a VC firm raising an energy fund must disclose to LPs if a partner's brother-in-law is the CFO of a large regional energy provider. Likewise, if potential conflicts arise while sourcing deals, VC firms must have specific procedures to address them. The fund manager may decide that the conflicted employee will not participate in decisions relevant to that particular investment. Alternatively, a fund manager may decide not to invest in a company because of particular conflicts. Some VC firms may have a specific committee to assess and address these issues. Each VC firm will have its own processes, but fund managers should be sure to notify LPs when conflicts are identified in order to protect LPs' interests and the VC firm's reputation. In such situations, a Limited Partner Advisory Committee (LPAC) can be helpful in assessing concerns and recommending the proper response.[40]

One item that the fund managers must disclose is their approach to partner co-investment in its deals. The fund managers are expected to contribute to the fund itself as a way to align their interests even more closely with those of the LPs. In addition, however, some VC firms allow the fund managers or even the employees to invest alongside the fund in its deals. In general, this right should be defined as a certain percentage established at the start of the fund—say, 1%. The worst approach allows the firm's employees and fund managers to choose the deals in which they invest. This "cherry picking" behavior can lead to substantial misalignment of interests, as a fund manager is much more likely to work hard on a deal in which she has invested than on one in which she has not. Best practice, then, calls for a set investment percentage or even the creation of a separate sidecar fund that invests a set proportion alongside the fund in every deal.

Once potential deals are sourced, they must be evaluated. The specific details of the process vary between VC firms, but it is usually carried out by one of the fund managers with the assistance of at least one other individual. Sometimes an entire team will diligence a deal. One angel investor estimates that evaluating an early stage deal requires 35 to 40 hours of work on average,[41] and only the rare few actually receive funding. One study found that only 0.6% to 4.0% of companies considered by a VC firm receive funding, while another estimated only 1.0% did so.[42]

One way in which fund managers ensure that they undertake exceptional due diligence is by clearly delineating roles and responsibilities throughout the process. While the specific assignments vary with each VC firm, two practices appear to be universally beneficial. First, the individual who will negotiate the deal and monitor the company should be intimately involved in its due diligence. Assigning a "champion" to each deal helps ensure that information is carried from one stage of investment to the next and that details are not overlooked. Such continuity also prevents the possibility that the initial team assumes that another group who takes over management of the company once in the portfolio would "fix" any problems. Second, the deal teams should repeatedly socialize deals, regularly discussing the results with other professionals at the VC firm. This allows colleagues to offer comments, questions, and advice that can direct the course of the

[40] For more on LPACs especially in LAC, please see Ann Leamon, Josh Lerner, and Susana Garcia-Robles, "The Evolving Relationship of LPs and GPs," *MIF Knowledge Product*, September 5, 2012.
[41] Andrew Blair of Business Angels International, cited in Expert Testimony of Josh Lerner, October 2, 2008, 10.
[42] W. A. Wells, "Venture Capital Decision Making" (PhD dissertation, Carnegie-Melon University, 1974), 47; and G. W. Fenn, N. Liang, and S. Prowse, "The Economics of the Private Equity Market," Federal Reserve Board, 1996; referenced in Expert Testimony of Josh Lerner, October 2, 2008, 10.

investigation, improving it as it unfolds. By continuously iterating this process, whether through well-established informal routines or a more structured review processes, fund managers can reduce the likelihood of unpleasant surprises.

An obstacle that presents itself at this stage—and persists throughout the investment—is information asymmetry, or the fact that the entrepreneur knows much more about his company than does the fund manager. Due diligence helps reduce this asymmetry. Through a comprehensive investigation, the fund manager gathers as much information about the company as possible. Many constraints, chiefly time, leave some questions unanswered. Given the information gathered and the questions that remain, the VC firm must ultimately decide whether or not to invest in the company.

Typically, VC firms will incur more costs for consultants—accountants, environmental experts, lawyers, and the like—as the due diligence process continues, and, in most VC funds in LAC, after the Investment Committee has initially approved the investment. Many fund managers have specific steps in the approval process at which consulting services will be retained. Some VC firms estimate the types and costs of outside counsel that will be required at the start of the due diligence process, and match the hiring of consultants with the critical decision points. For instance, an accounting firm may be engaged after the company has presented to the deal team and questions arise about details of the cash flow. If those are resolved satisfactorily, a legal team may be engaged when certain licensing agreements must be evaluated, and an environmental consultant might hired later on, when the deal team is exploring potential environmental liabilities or value creation opportunities.

The use of consultants in due diligence has benefits and drawbacks. These experts can often gather information quickly and thoroughly, "swarming" a deal and informing a quick decision. Yet because they invariably filter the material relayed to the deal team—any intermediary does so— they should be used sparingly. In addition, consultants have no incentive to stop asking questions, so bills can rise quickly. A careful process for hiring consultants, along with frequent approvals by the IC, can be an important cost savings for the fund. The "broken deal" costs can be significant if fund managers hire external expertise without clear questions to be answered and a clear process to follow.

Incomplete or rushed due diligence can cause partners to accidentally overlook important details in reviewing a potential investment. Several factors can "blind" partners to the negative characteristics of a company. Fund managers have shared cautionary tales of "falling in love" with a company—due to a charismatic entrepreneur, an intriguing business model, or impressive social impact—and failing to appreciate the risks it entailed. Socializing the deal across the firm can help to mitigate this risk. Another issue that can arise is "incrementalism," in which a company performs "well enough" through each step of the due diligence process, but the investment as a whole is not particularly promising. It is important that fund managers look at the big picture in addition to the details to make sure they do not confuse a *passable* company with a truly good investment.

The greater VC community still debates the relative importance of the "jockey" (the entrepreneur and management team), the "horse" (the business idea), and the "racecourse" (the market) in evaluating deals,[43] but the majority of LAC fund managers who contributed to this paper indicated that the quality of the entrepreneur is a crucial factor. Their combined experiences indicate that in LAC, extensively vetting a company's management team is essential.

A particular problem can be overestimating an entrepreneur's skills or leadership. Some entrepreneurs may be adept at running start-ups, but lack the ability to expand the company. One fund manager pointed out that even successful entrepreneurs in the region often have little basic business knowledge. If fund managers identify an entrepreneur's shortcomings, they can compensate by hiring support staff, employing an executive trainer, or —as a final step—by replacing him as CEO. Sometimes a CEO's shortcomings may be an appropriate reason not to invest at all.

In some instances an otherwise talented entrepreneur can be a difficult investment partner, refusing the venture capitalists' guidance and advice. A properly structured deal can help mitigate this risk, but it is difficult to anticipate all possible scenarios. If conflicts emerge, the entrepreneur—as well as the VC firm— must be trusted to exhibit true partnership behavior. As a result, multiple LAC VC firms indicated the importance of an entrepreneur's character—but evaluating character in a short time can be especially challenging. One Latin American (LATAM) firm has responded to this by stressing the importance of heeding "negative instinctive reactions to management" even if such sentiments exist only among junior staff.

Another clue to the development of the management team lies in its succession plan. Many start-ups are too busy to consider them, yet entrepreneurs are mortal. Fund managers should work with the entrepreneurs to determine how best to approach the question of succession and how to ensure that papers, processes, and even passwords can be accessed in the event of some tragic misfortune.

Many factors contribute to the importance of investigating entrepreneurs in LAC. Most significantly, the region's legal systems often favor the entrepreneur in disputes. Laws in some countries do not yet protect minority shareholders' rights. Other countries have passed these laws but lack consistent enforcement. One LAC fund manager mentioned a case in which a domestic judge acknowledged the legality of a fund manager's claims, but still ruled in favor of the entrepreneur because the investment contract seemed "unfair." Alternatively, judges may simply be untrained in the complex legal contracts that govern VC investments. Considering the intricacy of these documents, it is unsurprising that many judges would find the proper interpretation of the relevant laws difficult, and thus might rule in favor of the entrepreneur. Finally, the legal systems of many LAC countries suffer from extensive delays. If a portfolio company is in jeopardy, quick corrective actions are usually required—and may be prohibited if the VC firm is engaged in a prolonged legal battle. One LAC fund manager stated it clearly; "Investors

[43] Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "Should Investors Bet on the Jockey or the Horse?" (CRSP Working Paper No. 63, August 2007), available at http://ssrn.com/abstract=657721.

cannot rely on the law for protection." While fund managers must legally protect themselves, the first defense is to select entrepreneurs who possess both talent and integrity.

To address these challenges, LAC fund managers have recommended numerous methods for evaluating entrepreneurs. First, the deal team should not rush the due diligence process. As one fund manager put it, "A good investment takes a year of getting to know each other." While the exact amount of time may be debated, the wisdom is evident: take your time. A dearth of public records in the region makes this process more lengthy and difficult, and requires LAC venture capitalists to resort to other sources, often informal ones, for information. Many LAC fund managers use their extensive networks to address this issue, particularly since the business communities in many of these countries are tightly connected. VC firms should be able to find and consult other professionals who have experience with an entrepreneur and can affirm the entrepreneur's skills and character or warn the firm about his shortcomings. If a VC firm's network does not include professionals who have experience with a particular entrepreneur, it may indicate that they should not invest. At a minimum, the VC firm should evaluate the individual with great care.

A few fund managers suggested the use of a team dynamics consultant to examine the manner in which an entrepreneur directs and works alongside her team. In addition to helping the VC firm evaluate the entrepreneur's leadership, this approach will also provide information on other members of the management team, and on the team's ability to work together.

Deal sourcing and due diligence are only the first step through which VC firms create value in companies. It is followed by deal structuring, which can create the framework for creating further value. We considered this topic in the next section.

B. Deal Structure

An adage maintains that "90% of value is created before a deal is closed." Because of the long term nature of VC/PE investments, it is important that stakeholders' interests are properly aligned, incentivizing each individual to work for the company's success. Fund managers must structure investments to ensure that the fund managers and the portfolio company's management team win *together* by building a prosperous business. While one hopes that the personal integrity of the individuals involved will encourage them to act in good faith, a well-structured deal can help assure that interests are aligned and all will benefit from specific strategies. This section looks at the ways that careful deal structuring can create significant value and the potential pitfalls these efforts can confront.

Venture capitalists typically take minority ownership positions in their portfolio companies. The legal limitations presented by some LAC countries, however, make some fund managers use majority ownership to ensure their control rights over investee companies. This approach, however, presents specific drawbacks. It can greatly restrict a

VC firm's pool of potential investments, because fewer entrepreneurs are willing to part with majority shares of their companies, and the higher costs of majority investments mean that VC funds can afford to make fewer investments overall. Bella Research Group's independent findings also indicate that selling a majority position can be a disincentive to the entrepreneur by decreasing his sense of connection to the company. When entrepreneurs retain majority control, their reputations are tied to the continued success of the company, motivating them to create value. In 2010, David Wilton of the International Finance Corporation (IFC) shared comparative results of the organization's minority and majority positions in emerging market PE investments.[44] He reported that the average IRRs of exited minority investments exceeded those of its majority investments in every exit route. This difference shows the impact of high outlying results from the minority positions, as the *median* IRRs from every exit route except management buyouts showed minority investments slightly lagging (but comparable to) those of majority investments. The author ascribed the success of these minority positions to the fund managers' ability to establish themselves as valued partners in the portfolio companies, indicating the power of minority positions in creating value in these emerging markets.

Since venture capitalists generally take minority stakes in companies, they must take steps to protect their interests, most commonly by using preferred stock. Preferred stock is the well-established best practice in the U.S. VC industry. In emerging markets, however, fund managers use preferred stock less frequently, with an impact on results. A 2005 paper by Josh Lerner and Antoinette Schoar examined 210 developing country VC and PE investments and found that the characteristics of a country's legal system significantly affect the structure of private equity deals within that country.[45] The study found that investments in regions that more commonly used U.S.-style contracts, including preferred stock, had higher valuations and returns. A 2007 study also looked at VC outside of the U.S., collecting data on 145 investments in 23 countries by 70 different VC firms since 1997. [46] The study found that more experienced firms used U.S.-style contracts regardless of local legal regimes, and all firms that changed their contracting style switched to U.S.-style contracts. Additionally, VC firms that used preferred stock were significantly more likely to survive. Over 50% of the VC firms that never used preferred stock have failed, compared to only 8% of those that always used preferred stock.

While preferred stock helps protect fund managers' positions, the portfolio companies' management teams must also be incentivized to undertake value creating strategies. Often, the management team will be given stock in the company, whether currently vested shares, shares that vest over time, or, where legally permitted, stock options.

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[44] David Wilton, "IFC's Experience in Emerging Markets Private Equity," *EMPEA's Quarterly Review,* Vol VI, Issue 1, Emerging Market Private Equity Association, 2010: 6-9.
[45] Josh Lerner and Antoinette Schoar, "Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity," *The Quarterly Journal of Economics,* Vol 120, No. 1, February 2005, 223-246.
[46] Steven N. Kaplan, Frederic Martel and Per Strömberg, "How Do Legal Differences and Experience Affect Financial Contracts?" *Journal of Financial Intermediation*, 16 (3), July 2007, pp 273-311

Enabling Value Creation

If the first function of deal structuring is to *incentivize* future value creation, then its second function is to *enable* it. VC deals create the tools that investors have at their disposal during the life of the investment. There are a wide range of specific covenants that a VC firm can include in a deal to address particular situations, but by and large VC firms use tranched payments linked to milestones, and key governance rights, including board seats and information rights, to influence their portfolio companies.[47]

Covenants

Governance rights establish the ability of the fund manager to participate in the company's strategic direction. They are usually enshrined in the purchase agreement as covenants. The most important is the **board covenant**, which describes the size and composition of the company's board of directors and is discussed separately later on. Also critical are **information rights**, which range from the company's agreement to merely disclose year-end audited financial statements to permission for the fund managers to inspect the company's financials at any time. Information rights may also apply to the provision of other documents, such as an annual budget to be prepared 60 days before the start of the fiscal year.

Other types of covenants define both what the entrepreneur must do (positive covenants) and what she is restricted in doing (negative covenants). The most important positive covenants include producing audited reports, holding regular board meetings, paying taxes on time, and preparing annual budgets. (Note that while the positive covenants require the portfolio company's management team to do this, the information rights give the fund manager the right to inspect the reports.) Negative covenants limit behavior that would adversely affect the value of the company and thus that of the investors' ownership. Sometimes the behavior is forbidden outright; others require the approval of the board. These actions may include the sale of assets, the assumption of debt, or the disposal or purchase of assets above a certain value. Change in control is another concern for fund managers—after all, the fund manager expects to be backing *this* management team—and managements' sale of its shares may be restricted. Finally, the issuance of new shares without board approval is usually restricted. Yet just because it is restricted does not mean it is prohibited, because a subsequent fund-raising often requires exactly that. The critical point lies in the board's approval of the matter.

A few other important covenants are neither positive or negative. One is the right of mandatory redemption, which allows the fund manager to sell the preferred stock back to the company in five to eight years; and registration rights, which would allow the venture capitalist to force the company to go public. Both of these are rarely enforced, as one can assume that if the company were capable of redeeming the stock or going public, it would have done so already! But including them acts as a reminder and, in worst case, can help the fund manager create change in a difficult situation.

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[47] For an extensive discussion of covenants, please see Lerner, Leamon, and Hardymon, Chapter 5: Deal Structuring.

The importance of covenants lie in the way they disconnect control on important issues from the ownership of a majority share of equity. With appropriate covenants, a fund manager with a minority stake in the portfolio company still has the power to direct it from the board level. If a fund manager cannot obtain sufficient covenant protection, he should reconsider acquiring a minority position.

Milestones

Multiple LAC fund managers noted that their influence over portfolio companies declined after the capital was delivered. Since money is venture capitalists' ultimate bargaining chip, the use of tranched payments, in which VC firms release committed capital to portfolio companies upon the achievement of a certain value creation milestone, offers many benefits. The milestones set clear checkpoints and ensure that the CEO is pursuing the agreed-upon growth strategy. Milestones can vary greatly based on the details of an investment, but generally reflect distinct points of value accretion, such as developing a prototype, getting a product to testing, hiring a chief marketing officer, reaching cash-flow breakeven, or opening a specified number of new branches. If the company misses a milestone, its management and the board of directors initiate corrective measures. Fund managers may re-evaluate future funding. Injecting capital as the company needs it grants VC firms additional bargaining power when the company is underperforming and most in need of guidance. It also allows VC firms to curb their losses if it becomes clear that a portfolio company will fail. Several LAC fund managers noted that delivering an entire investment in one payment when the business did not require it was an unnecessary risk.

Structuring a deal to include milestones also facilitates the company's future fund-raising. Often, VC-backed companies raise additional capital over their lifespans, and doing so after achieving a milestone usually increases the company's valuation. Thus, the company's later round occurs at a higher price per share, meaning less dilution for the existing shareholders (particularly the executive team).

Raising later higher priced rounds is good for the portfolio company, but can pose a challenge for the VC firms invested at the time. If a VC firm managing a small fund has a very successful company in its portfolio, it may find itself priced out of later rounds as the company's value rises. In such a situation, there is little that the small fund can do as its ownership gets progressively diluted. It can, if it wishes, sell its position into a later, high-priced round. Other approaches, such as trying to negotiate a guaranteed percentage of future rounds, tend to impede the company's growth—which is hardly in the fund's best interest.[48]

[48] Interestingly, Microsoft encountered a similar issue and could not determine a good resolution. Through its IP Ventures program, it spun out surplus (but viable) IP into start-ups that received funding from Silicon Valley VC operations. Several companies were quite successful, but Microsoft de=-emphasized the program in part due to the dilution problem. Because Microsoft had decided not to invest anything in the company beyond the original IP, for which it received 20% to 30% equity, its position invariably was diluted. For more, see Josh Lerner and Ann Leamon, Microsoft's IP Ventures, *HBS Case No. 810-096* (Boston: HBS Press, 2010).

Governance and Boards

Effective governance structures are another component of well-crafted deals. As the literature review indicates, the governance systems that VC/PE firms implement in their companies create tangible value. The centerpiece of typical VC/PE governance structures is the board of directors. In fact, a recent study by Adrian Lei and Frank Song found that a well-structured board is the most significant corporate governance mechanism in an emerging market company.[49] Since boards are the means through which venture capitalists influence companies during the life of a deal, fund managers must ensure that these bodies are properly structured and utilized. The size of a board must reflect the needs of the company, with enough directors to express diverse opinions, but few enough to allow ease of communication.[50] Younger companies generally have smaller boards than older companies, reflecting the addition of investors during further rounds of financing.

In general, boards of VC-backed companies range between four directors, at the first round, to six at the fourth.[51] The selection of directors is significant. According to Josh Lerner's study of 271 biotech firms, venture capitalists generally averaged between one and two board seats, independent outsiders averaged around one seat, and insiders typically held between one and two seats.[52] Additionally, quasi-insiders – individuals who do not work for the company, but have an ongoing relationship with it – held 0.52-0.67 seats on average. It is important that boards include independent directors because, in addition to their expertise, they provide valuable outside perspective, unaffected by close involvement with the company.

John A. Davis described a number of best practices for boards of directors.[53] His recommendations—among them, meetings four to six times a year lasting from a half day to one and a half days and focusing on long-term issues—apply to more established companies than the typical VC-backed operation. For most VC-backed companies, board meetings are monthly at least; sometimes weekly if the company is very new or struggling. Noted a U.S.-based venture investor, "When a CEO is overwhelmed, he hides. Your job as an investor is to find him." Such "finding" can include frequent board meetings—or unexpected visits to the office.

Information rights contribute to the effectiveness of the governance process. Due to the informational asymmetries in a VC relationship, management generally knows more about the company than do the investors. Unlike public companies, private companies are

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[49] Adrian C.H. Lei and Frank M. Song, "Board Structure, corporate governance and firm value: evidence from Hong Kong," *Applied Financial Economics*, (2012): 1289-1303.
[50] John A. Davis, "Reminders for Owner-Managers Regarding the Board of Directors of Private Companies," *Harvard Business School Case No. 805-154* (Boston: HBS Press, 2005).
[51] Josh Lerner, "Venture Capitalists and the Oversight of Private Firms," *Journal of Finance* 50, no. 1 (1995): 301-18.
[52] Ibid.
[53] John A. Davis, "Reminders for Owner-Managers Regarding the Board of Directors of Private Companies," Harvard Business School, revision 2006-5-15.

not required to disclose specific information at predetermined times—but minority shareholders must access to the needed information to fulfill their monitoring function. Thus the deal structure must establish these reporting standards. Their exact structure depends on the nature of the company and its industry, along with the locally applicable financial reporting requirements. In fast-paced industries and countries with particularly volatile economies, portfolio companies may need to report more frequently to the fund manager. One LAC fund manager recommended the use of monthly reports, both to identify problems quickly and to encourage regular reflection by the executives. Such reports can also serve as a central source of historical performance data that will aid fund managers in assembling critical information if an unexpected exit opportunity arises.

Reporting to LPs

Reporting and valuation standards have caused consternation among LPs and fund managers for decades. In LAC, where the VC industry is fairly young, reporting should be more frequent than less and valuation should be conservative. In a typical quarterly report the fund manager provides basic information such as a summary letter, balance sheet, a schedule of investments (what was invested in when), a statement of the fund's operations (investment income, fund expenses, net operating gain/loss, realized/unrealized gains and losses on investments), a statement of cash flows from operating and financing activities, and the partners' capital account statement, along with a portfolio company update. The partners' capital account statement shows the net asset value for the current and prior periods, along with the fund managers' balances, the LPs' balances, the contributions and distributions for the given period, and the commitments of LPs and fund managers.[54] One very important part of the reporting package is the portfolio company update, which describes the company, its business, the VC firm's investments over time, and any important news. LPs do not like surprises, yet early stage companies do not progress in a linear fashion. Therefore, fund managers should prepare LPs to the extent that they can—particularly if the company's performance is falling short of expectations. It is critical, however, that good news, such as a possible liquidity event, should be broadcast only when the transaction is complete due to the uncertainties associated with these transactions.

Several long-time LPs have noted the usefulness of a cover letter that describes the country's macro-environment and the process of the fund in general and gives highlights (and lowlights) of the companies in the portfolio. Especially when the LPs are unfamiliar with the country in which the fund is operating, background information from trusted observers—the fund managers—can calm concerns raised by the wider media.

Valuing early stage companies is a difficult proposition. Overnight, the value can drop or rise dramatically as products fail or succeed and customers delay or purchase. The long-

[54] For an exhaustive description of Best Practice reporting, please see templates provided by the Institutional Limited Partners Association (ILPA), http://ilpa.org/ilpa-standardized-reporting-templates and a detailed discussion at the IPLA website, http://ilpa.org/wp-content/uploads/2011/02/ILPA-Best-Practices-Reporting-FAQ1.pdf. This best practice version may need to be adjusted for the realities of information availability.

time convention in the U.S. was "higher of cost or last round unless impaired."[55] This reflected the sense that the best idea of a company's value occurred when outside investors priced their investment in it. While this approach provided happy surprises in strong markets, it required a strong will to mark good companies down in bad ones and could be gamed. We suggest that fund managers rely on communication and clear, regular reporting, and a consistent valuation approach to keep LPs informed.[56]

Fund managers face several challenges in properly structuring deals, especially in emerging markets. A common issue reported by LAC fund managers was insufficient minority protection rights. Without sufficient control mechanisms in place, fund managers are unable to provide high-level guidance. When portfolio companies begin to underperform, these control mechanisms are often the only way for venture capitalists to intervene. For example, some venture capital deals are structured so that control shifts to the VC firm if the business underperforms. In such situations, the venture capitalists can then try to save the company, protect its investment—or, at worst, engineer an exit. As one fund manager noted, "Never create a structure that lets others control the fate of the company."[57]

A properly crafted deal improves the portfolio company's chances for success by providing information and control rights that empower venture capitalists to intervene when necessary. The next section more closely examines the post-deal stage of the investment, in which the VC firm monitors and guides its portfolio company to generate value.

C. Deal Management

Once the due diligence is complete and the deal is finalized, venture capitalists begin the process of monitoring and guiding the portfolio company. This stage of VC investment has garnered increased attention in recent years. There are many ways fund managers create value during this stage, and many challenges they face along the way. This section will examine this part of the VC investment cycle and describe the best practices that help venture capitalists succeed.

During this period, the venture capitalist monitors the company's performance from the board and helps it execute its growth strategy. One 1984 study collected responses from

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[55] Valuation has since become complicated by the adoption in the U.S. of Federal Accounting Standards Board Rule 157 (the Fair Value Standard) and a similar rule in the IFRS system. For a description of these changes, see Josh Lerner, Felda Hardymon, and Ann Leamon, "Between a Rock and a Hard Place: Valuation and Distribution in Private Equity," *Harvard Business School Case No. 803-161* (Boston: HBS Press, 2011).
[56] For more on valuation, see Lerner, Leamon, and Hardymon, Chapter 4, and "Measurement, Governance, and Long-Term Investing," a publication of the World Economic Forum, March 2012, *WEF_IV_MeasurementGovernanceLongtermInvesting_Report_2012.pdf*.
[57] For more on this, see Steven N. Kaplan and Per Strömberg, "Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts," *The Review of Economic Studies*, Vol. 70, No. 2 (Apr., 2003): 281-315; and Ola Bengtsson, "Covenants in Venture Capital Contracts," *Management Science,* Vol. 57, No. 11 (November 2011): 1926-1943.

49 VC firms—representing about 40% of the industry's assets under management at the time—and found that most venture capitalists spent more than half their time monitoring portfolio companies.[58] A chief concern, then, is to ensure that the firm has the right representative on the board. Ideally, the same venture capitalist will guide a company from the initial due diligence to the final exit, but in some cases the board member may change, whether due to illness or, more severely, a conflict with a CEO or other board members. While switching representatives is far from ideal, it recognizes that different individuals' strengths may suit them for some situations and not others. It is far better to switch the board representative than to allow governance to fail. As in all stages of an investment, fund managers should regularly discuss their deals with the other partners at their firms, to keep everyone up to date on developments and to solicit their input in resolving challenges.

An important part of managing investments is the enforcement of milestones. Multiple LAC fund managers reported experiences in which they wished they had more strictly enforced milestones and not released additional tranches of capital. For several, injecting capital despite a missed milestone increased the losses they suffered. Such a move also forfeited the opportunity to exercise positive influence that could have salvaged the investment or at least reduced losses. At the same time, VC firms should not indiscriminately withhold all future payments when companies miss milestones. Rather, fund managers may prefer to withhold capital until the company and the board have identified the problem and decided upon the best response.

Venture capitalists also provide guidance to improve portfolio companies' management and operations. As illustrated in the literature review, VC and PE firms have shown remarkable success in this task. Fund managers might recruit additional management expertise through their network, or supply executive trainers to the management team. Some VC firms possess operational experts who can provide direct, hands-on assistance as temporary CEOs or other executives for assignments of varying duration. Fund managers need to choose an approach that reflects the needs of the company and the abilities of the VC firm itself. Sending the CFO to a struggling portfolio company would do the fund a disservice, but assigning a bright MBA analyst to help with accounting or marketing can both support the portfolio company and provide the analyst with important experience. If a fund has an excess of needy portfolio companies, though, the fund managers may need to revisit the due diligence process or consider recruiting talented operations partners.

Choosing the right approach in assisting companies is especially important in LAC. Because many entrepreneurs lack extensive business training, they often need more support than entrepreneurs in developed countries. Moreover, finding talented executives is also more difficult—experienced CFOs, for instance, are invariably scarce. Fund managers generally try to develop the skills of current managers through incubators, executive trainers, and consultants.

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[58] Michael Gorman and William A Sahlman, "What Do Venture Capitalists Do?" *Journal of Business Venturing* 4, no. 4 (1989): 231-49. The firms were based in the United States, which dominated the VC industry at the time.

Developing the current managers can address skills gaps while preserving the current team dynamics and the managers' commitment to their companies. If a team functions well together, it may be better to preserve it and augment its skills. By empowering current management with additional training, the team may retain a strong sense of ownership and responsibility for the company.

To improve internal skills, venture capital and other PE firms may employ proven business leaders to serve as coaches and mentors. One LAC VC firm briefly operated its own incubator to help develop start-up entrepreneurs and their businesses, but later decided to collaborate with external incubators. In other cases, external coaches or consultants may be preferable. Here, a fund manager's professional network can be particularly beneficial. In another example of leveraging the management team, one LAC fund manager operates a wholly-owned subsidiary company that assumes the administrative and back-office tasks for its portfolio companies, allowing the CEOs to focus entirely on the core business concerns. These services ensure that basic business needs are met consistently without interfering with the company's development.

While hiring new talent can fill skills gaps, the approach can create several problems. Just finding individuals with the necessary skills in LAC can be challenging. Finding skilled mid-management with potential is one of the challenges in LAC. Unlike developed markets, many emerging markets lack a cadre of managers with specific financial, managerial, or engineering skills. Assuming one can be found, current managers and staff may be reluctant to accept the new hire, especially if the individual is replacing an existing team member. In family-run companies, simply reaching agreement on the need to replace a family member can be excruciating.

Once the company is adequately staffed, fund managers must monitor its performance without interfering in day-to-day operations. Company underperformance may be attributable to poor implementation or to flawed strategy. In the first situation, specific changes must be made, whether in staffing or approach, while in the second, the company must develop a new strategy. In either of these scenarios fund managers create value by advising portfolio company executives as they redesign aspects of their business, including product offerings, suppliers, pricing structures, and customer targeting. One LAC manager's portfolio company offered a good product for which no market existed in the region. The VC firm redesigned the strategy to utilize the same technology and core competencies, while addressing a different market need. In other situations, fund managers assisted management teams in identifying the profitable and unprofitable segments of their customer strategies, helping the companies to focus on the more profitable product lines. Another VC firm guided its portfolio companies in pursuing methodical geographic expansion. In many of these cases, LAC fund managers stressed the importance of identifying issues early and addressing them promptly. The figure in Appendix 1 illustrates some basic business requirements as a company evolves from an idea to a more developed enterprise. The chart is not exhaustive, and portfolio companies may not fit precisely in any one category, but the framework may aid fund managers in thinking about and anticipating the needs of portfolio companies as they mature.

A critical part of implementing business changes—regardless of rights written into the contract—is the relationship established between venture capitalists and the CEO. Foremost, fund managers should exhibit good partnership behavior towards their entrepreneurs, exercising influence through persuasion and negotiation. It is very difficult for fund managers to create value in portfolio companies when they are combating the entrepreneur. By explaining the logic behind suggestions and convincing entrepreneurs to agree, fund managers can more effectively guide their portfolio companies. This is especially true in LAC where poor contract enforcement may favor entrepreneurs in cases of legal conflict.

Part of the challenge facing LAC fund managers is the degree to which entrepreneurs are willing to accept guidance. Such openness to advice is often more common in more advanced markets, where the guidance that comes with venture investment is recognized as an important part of the value provided. Clearly defined methods for value addition offers several advantages. Not only can the venture capitalists prepare the entrepreneur for the changes to come, but they can engage the entrepreneur's interest and support from the start—or, by gauging the depth of opposition, decide whether or not to continue the diligence process. In addition, such a process can allow the fund manager to distinguish itself to LPs. Small funds, however, with lower fee streams may believe they cannot afford such approaches, but may find that investing in such structure saves time and money and provides better long-term results.

One fund manager noted that part of working effectively with entrepreneurs is recognizing cultural differences. LAC's wealth of cultural diversity can at times translate into misunderstandings or poor communication, and may be a particular concern for fund managers who received training outside the region. Many LAC countries have a more relaxed approach to business. The more rigid business style employed in the United States, for instance, may need to be adapted to these regions. An example is the issue of timeliness. A fund manager may be upset when a meeting is supposed to start at 10:00 and the entrepreneur does not arrive until 12:00, or if a report that is due on a certain day only appears much later. Fund managers must identify these differences and address them both by setting clear expectations and by adjusting their approaches to be more compatible with the entrepreneur's. A LAC fund manager noted that venture capitalists should handle these differences gently to maintain effective relationships with their entrepreneurs.

If conflict does erupt, fund managers should first seek to repair the working relationship with their CEO. In some situations, though, a resolution may be impossible. It is important, then, that fund managers do what they can to protect the company, reflecting both their fiduciary duty to LPs and their commitment to creating sustainable value for the company's stakeholders. The possible approaches will depend on the contracts negotiated in the initial deal and the enforceability of its provisions. For example, since debt structures may be easier to enforce than equity structures in some LAC countries, a fund manager may have structured a note that will shift ownership to the VC firm if the portfolio company cannot pay. While this structure can protect funds against worst case scenarios and serve as a bargaining chip with entrepreneurs when conflict arises, fund managers should only use such measures as a last resort. As one fund manager put it, "A note holder is like a person with a nuclear bomb and a big red button." While it may offer a degree of negotiating power, no one wins when it is used.

Another matter of concern in such situations is the VC firm's reputation. While VC firms thoroughly investigate entrepreneurs before investing, entrepreneurs similarly investigate VC firms. Since public records and business documentation are less readily available in much of LAC, reputations are very important in judging business partners. If a VC firm is perceived as mistreating entrepreneurs, other potential portfolio companies may avoid them in the future. Additionally, defamation laws in many LAC countries are difficult to enforce, which complicates efforts to prevent disgruntled entrepreneurs from vilifying fund managers, even if their claims are untrue.

In addition to creating value in portfolio companies' operations, venture capitalists can help portfolio companies create social value by encouraging the adoption of environment, social, and governance (ESG) practices. One aspect of this approach usually involves ensuring that labor is treated according to global standards and compensated at the country's minimum wage, or better. Not only can such a strategy improve labor retention, but it can also set a precedent that raises working standards across the larger regional landscape. ESG strategies can also reduce negative environmental impacts from companies' operations through initiatives such as monitoring and reducing a company's energy use; ensuring that waste is minimized, recycled, and/or properly disposed; and increasing logistical efficiency. These practices not only benefit the environment, but can also create value for the portfolio companies through lower power bills or lower costs for trash disposal due to recycling efforts. Moreover, these strategies can boost a company's public image and its attractiveness to potential acquirers. One LAC fund manager reported that acquirers had noted with approval the quality of the portfolio company's labor and environmental practices. These less tangible factors translated into real value in the final acquisition.

In emerging markets, using an externally recognized benchmark such as the Global Impact Investment Rating System (GIIRS) offers another way of creating value through ESG. In many of these markets, so much is uncertain and unfamiliar to global investors or DFIs that a recognized benchmark, whether ILPA principles for a fund or GIIRS for a company, offers reassurance. The actual score on the benchmark can be less important than the fact that the organization is aware of the scorecard and has looked beyond its immediate domestic or regional comparisons. In addition, such standard can be helpful if the portfolio company plans to export its products.

During the life of a deal, venture capitalists strive to create value in their portfolio companies. Eventually, the company will reach the limits of the venture capitalist's ability to add value. At this point fund managers realize the value they have created through an exit. The next section addresses this final step in the life of an investment, and illustrates the ways in which a successful exit can create additional value.

D. Exits

Exits signal the conclusion of VC investments, but they are a prime focus from the beginning. VC investments are finite by design. As one fund manager phrased it, "We must enter the room with our eyes on the exit sign."[59] Exits enable LPs and fund managers to reap the benefits of their investments, motivating the entire VC process. This section of the report will outline some best practices in exiting companies, and illustrate how well-executed exits create additional value.

The importance of planning for an exit from the initial due diligence cannot be overstated. Fund managers should consider all possible exit options and integrate them into the investment decision, the structure of the deal, and the steps taken during the investment's life. They should structure management incentives for each exit route to ensure that no matter which exit presents itself, managers will be willing and able to close the deal. CFOs, for instance, are vital to the success of the acquisition process yet often lose their jobs afterward, and thus must be properly incentivized and compensated.

In addition, portfolio companies should follow best business practices to remain prepared for potential buyers. As one LAC fund manager stated, "We had been preparing for this moment [the exit] from the beginning of the fund." He went on to note that through the life of the fund, he and his team intentionally managed each investment so that when a potential exit presented itself, they were ready to show "agility in the execution of selling the assets." Ensuring that companies continuously maintain proper documentation, reporting, and governance procedures can be crucial in exits that require fast execution.

The health of a portfolio company is often the most important factor in achieving a profitable exit, but many additional factors can help to improve a company's appeal to private buyers and public markets alike. ESG programs that reduce environmental impact, ensure adherence to global governance and labor standards, and aid businesses in running lean and efficient operations can help facilitate exits. One LAC fund manager, for example, recounted that the rising cost of energy increased the value of the energy-efficient systems that the portfolio company had installed and thus helped to attract a buyer. Similarly, certifying a portfolio company or its products with international standards groups, as noted earlier with GIIRS, can immediately increase the enterprise's prestige, improve its public image, and make it more attractive as an acquisition.

Before briefly looking at the various exit routes, it is important to stress that fund managers should consider every exit opportunity that presents itself. An adage maintains that companies are bought, not sold. Fund managers may turn down early chances to exit in the hope of a more profitable sale in the future. Unfortunately, future exit opportunities are not guaranteed. As the recent global financial crisis proved, the economic and business landscape can change quickly. It may make sense to hold out for better acquisition offers or for the IPO climate to improve, but fund managers must weigh those

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[59] Alan Gillespie of CDC Capital Partners, at that point, an early-stage impact investor, Ashbury Park, December 2000.

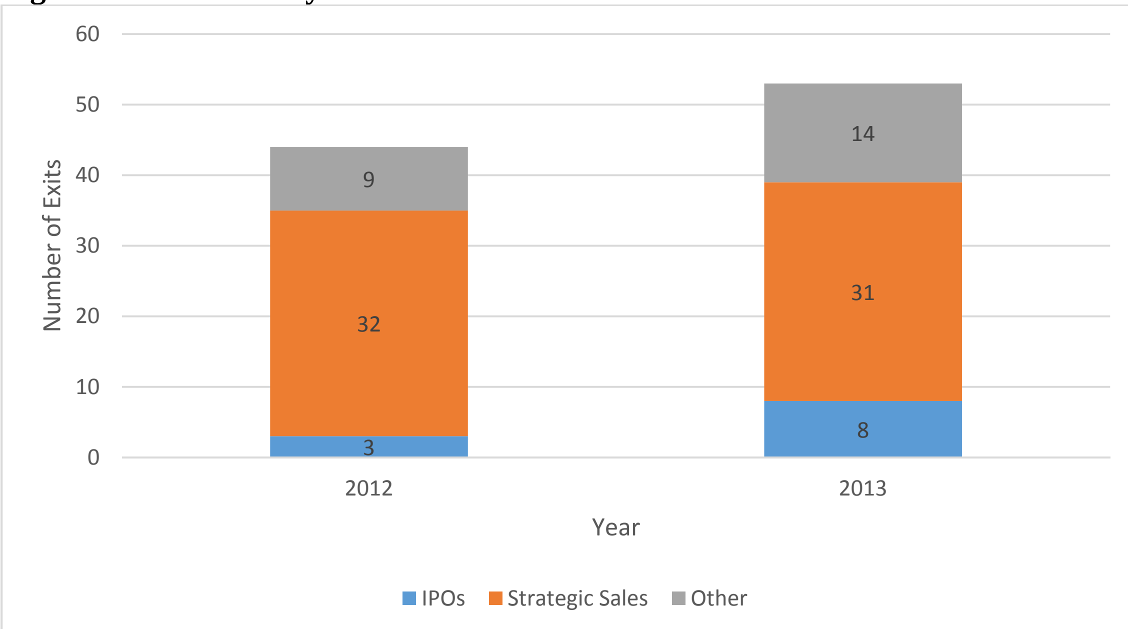
promises against the possibility that things may get worse, and future opportunities may be scarce.

Each exit route – acquisition, IPO, or management buyout – responds to certain needs of exited businesses, and can create parting value in portfolio companies. While VC firms have expertise within their specific niches – industries, regions, stages – they eventually exhaust the value they can create. At that point they can choose an exit that provides for the future needs of the business, allowing it to continue to grow in value and stability. LAC has seen several notable exits in recent years. These include Sembrador's 2013 sale of five portfolio companies to Joyvio, the agribusiness arm of China-based Legend Holdings Corporation, and DGF Investimentos' sale of Mastersaf, the Brazilian tax software developer, to Thomson Reuters in 2011 after a one-year hold. Among the IPOs of LAC companies were Stratus Group's listing of portfolio company Senior Solution on the BOVESPA MAIS in 2012. In addition, Riverwood Capital's exit of its Argentine portfolio company Globant via IPO on the NYSE in 2014 made it the first Latin American software company to list on the exchange.

Figure 4 displays the mix of VC/PE exits realized in LAC during 2012 and 2013. As shown in the graph, acquisitions (also called strategic sales) are the most common exit routes. More than half of all LAC exits in 2013 were through strategic sales.[60] Buyers with headquarters in LAC acquired 42% of the companies exited through acquisitions in 2013, while U.S. and Asia-based companies were also active acquirers.[61]

[60] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital*, LAVCA, 2014: viii.
[61] Ibid.

Figure 4: LAC Exits by Route 2012-2013[62]



Source: LAVCA's 2013 and 2014 Industry Data & Analysis Reports

While acquisitions or strategic sales lack the excitement of an IPO—and, often, the premium, which has been estimated at 22%[63]—they have a number of benefits. First, they are applicable to smaller companies, which are essentially shut out of public markets. Secondly, acquisitions offer fund managers a quicker and more complete exit at a more predictable price than an IPO, in which market changes may erode the initial valuation. Yet the issue is finding the acquirer.

Here the fund manager needs to show her knowledge of the industry by playing matchmaker. Sometimes a small acquisition is arranged through word of mouth; larger ones involve the preparation of a "bank book" that describes the operation and provides a valuation. Once again the company is the subject of due diligence, this time from the interested potential acquirers. The fund manager is deeply involved in assisting the company in providing the information and in smoothing out issues that invariably arise. Among many points of negotiation, in addition to the price, will be the terms of the acquisition and its timing. Some payouts are contingent upon the achievement of milestones; others are in the stock of the acquirer; still others are simply in cash.

LAC fund managers can enable acquisitions in many ways. Venture capitalists can maintain a list of potential acquirers from early in an investment, including those companies that fit strategically, with special attention to potential synergies and

[62] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital,* LAVCA, 2014. and Latin American Private Equity and Venture Capital Association, *2013 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital*, LAVCA, 2014: vii.
[63] James Brau, Bill Francis, and Ninon Kohers, "The Choice of IPO versus Takeover," *Journal of Business* No. 76 (2003), 583-612.

complementarity. Portfolio companies can then position themselves to court these companies, perhaps entering into strategic alliances early to build relationships that may turn into exit opportunities.

IPOs also create value in companies. Successful IPOs— typically the exits for which entrepreneurs strive—can be proud moments for fund managers and executive teams alike. For fund managers, these exits indicate that their portfolio company has become stable enough to survive in the public market and certifies their VC firm in the eyes of the VC/PE community. This can result in more successful future fundraisings, greater deal flow, increased willingness of founders to accept investments, and greater attention by other fund managers who may wish to syndicate future deals. An IPO draws greater attention to the portfolio company too, and validates it to outsiders. The reputational benefits can help in attracting customers, talented employees, and strategic partners. Also, top executives are more likely to keep their jobs in an IPO than in an acquisition. Taking a company public benefits society by allowing smaller investors to reap capital gains from its success. In many LAC countries, IPOs can have even greater significance, since there have been very few VC companies exited this way. Less developed regional stock exchanges benefit from the addition of each new thriving company, developing the economic attractiveness of the region. Even if a LAC company lists on an exchange outside the region, it draws increased attention to the region's ability to produce valuable companies worthy of investment, and raises its profile with the international investment community.

IPOs, however, come with their own concerns. Companies must undertake an arduous preparation process. The company's financials must conform to the standards accepted by the stock exchange on which it will list, and should show steadily improving results. The management team needs to be prepared for the IPO process and capable of running a public company, and the board of directors often needs to be reconstituted. For these reasons IPOs are relatively rare—in fact, they accounted for only 15% of all 2013 VC/PE exits in LAC.[64]

IPOs are usually chosen as an exit route if the company is large, has a significant place in the market, has high growth, and needs non-debt funding for continued investment. In addition, companies choose IPOs if the CEO has strong control rights or if the investors plan to maintain their position.[65] Yet IPOs are expensive, as the direct fees alone can reach 10% of the money raised, and may be delayed if market conditions worsen. The pre-IPO process itself can take months, as companies change the board and executive team, develop a track record of steadily rising earnings, choose an investment bank, go on the roadshow to recruit institutional investors, file the necessary paperwork, and price and execute the offering. If the fund manager owns sufficient stock to be classified as an "insider," most exchanges will require a lock-up period ranging from six months to a year

[64] Latin American Private Equity and Venture Capital Association, *2014 LAVCA Industry Data & Analysis: Update on Latin American Private Equity and Venture Capital,* LAVCA, 2014: vii.
[65] Lerner, Leamon, and Hardymon, p. 205.

before its stock can be sold.[66] As might be expected, though, entrepreneurs tend to prefer IPOs to acquisitions, because they retain their jobs.

For companies that may not be suited for the above exit routes, management buyouts (MBOs) can offer a path to liquidity. This strategy is often not preferred by fund managers because other exit routes generally provide greater monetary returns, but MBOs can offer reliable ways to realize value. Since fund managers consider exit strategies at the dawn of an investment, many negotiate MBOs at agreeable terms when structuring the initial transaction. For instance, fund managers can structure "put" options, ensuring the opportunity to sell their position back to the owners at a particular time and price. These are useful fallbacks if a fund must exit before it finds a buyer for the company. Such deals can specify the manner in which funds' positions are bought out, for instance by setting aside a share of profits throughout the life of the investment to ensure sufficient liquidity. Thus, MBOs allow fund managers and investors the security of a reliable exit route, while preserving the opportunity for more profitable exits should they arise. It is important that fund managers use the same care in executing MBOs as they do in other exits, ensuring to the extent possible that companies are prepared to survive on their own. Planning for this route in advance helps ensure that the companies can buy back the fund's position and retain enough capital for the future.

Fund managers face yet another challenge in working with entrepreneurs to engineer exits. Sometimes, an entrepreneur wants to exit before the maximum amount of value has been created. Dazzled by the chance to double her investment, she resists the risk and work of achieving a quadruple return in a year. On the opposition end, an entrepreneur may wish to hold the company beyond the optimal exit time for the venture capital firm. Structures such as puts can help ensure that expectations are aligned and the firm is better positioned to avoid unhappy surprises.

E. The Firm

Before wrapping up a discussion of best practices, it is important to discuss the internal practices that will help funds create value for their portfolio companies, for their LPs, and, in so doing, to grow the industry in LAC overall. Fund managers can create value for their VC firm by developing strong networks. One long-time LP noted, "The first-time fund managers who were successful for us had a good network that helped them in their initial fundraising and their pipeline development, and also helped companies access their own networks for growth. Of course, these networks then created better options for their exits."[67] The section on deal sourcing and due diligence detailed the importance of defining the realm in which firms do and do not invest, and maintaining a clear understanding of how the firm creates value. It also stressed the importance of clearly delineating internal responsibilities and ensuring that one person or team takes particular

[66] For more on the process of IPOs, see Lerner, Leamon, and Hardymon, pp. 209-219, and Josh Lerner, "Note on the Initial Public Offering Process," *HBS Case No. 200-018* (Boston: HBS Publishing, 2007)..
[67] Susana Garcia Robles, "The Multilateral investment Fund: Lessons Learned Building a Local Venture Capital Industry in Latin America and the Caribbean," *Venture Equity Latin America* and *Latin America Law & Business Report*, 2011.

ownership of each deal. An additional internal factor that affects value creation is the flow of wisdom across the firm.

Value on an industry level is also created through close alignment and open communication between the fund manager and the LPs. Best practices include regular reporting that ensures no surprises, along with a partnership orientation toward them. Similarly, communication and partnership behavior should also distinguish the fund manager's interaction with the entrepreneurs.

Numerous LAC fund managers shared their personal experiences to contribute to this white paper, and a number of important lessons emerged from the discussion. In the same way, the fund managers must establish internal processes by which the team reflects on investments, identifies best practices, acknowledges mistakes, and gathers lessons for future investments. Such "post mortems" help prevent the team from repeating mistakes or neglecting important lessons. It is equally important that this wisdom, once generated, is shared throughout the VC firm. A list of lessons is only valuable if fund managers read, reference, and utilize it to improve future deals. Each VC firm must develop methods that reflect its unique culture. Some fund managers may rely on more informal techniques to generate and disseminate this knowledge, while others may prefer structured processes like an annual "Lessons Learned" report or strategy retreats. Some VC firms keep a list of investments that went wrong and create a brief analysis of how to avoid or address similar issues in the future. As VC firms share lessons throughout the LAC VC industry and with their LPs, they will contribute to a healthier overall business environment.

It is easy to neglect the important role of reflection and network building when the day seems filled with more pressing matters. Both are nevertheless essential to a VC firm's success. Fund managers should recognize this by creating internal mechanisms that ensure the fulfillment of these vital steps in the value creation process.

III: Final Thoughts

Venture capitalists have numerous tools and opportunities to create value in their portfolio companies, but the task of successfully manifesting this value can be daunting. The unique challenges posed by each investment, difficulties in collaborating with portfolio company managers, and unexpected macroeconomic factors all contribute to VC's complexity. The young VC industry in LAC faces a number of particular challenges in this regard. LAC's legal and institutional infrastructure is evolving; formal business training is relatively rare; and volatile economies can complicate companies' business activities. For these reasons, LPs must be convinced of the ability of the region's venture capitalists—especially first-time fund managers—to respond to these challenges and create value in their investments.

Some of the most important practices are the most straightforward: behaving in a partnership manner with entrepreneurs and LPs. While the specifics differ in each situation, the fundamental precept of honoring the contributions and concerns of others is unchanged. Fund managers need to ensure that interests are aligned and that the management team has a sense of the future. Like the LPs, the management team should not be surprised: if the entrepreneur will be replaced or demoted, that news should be conveyed early in the context of setting expectations and creating value for the future. Similarly changes in vendors, in location, or in distribution channels should be made collaboratively.

Of course, sometimes collaboration is impossible. In such a situation, the fund manager must focus on the fiduciary duty owed the LPs and search for solutions that, at best, create value and at least, prevent losses. Two very bad strategies are "We've already spent so much" and "We hope…" The first invokes the "sunk cost" fallacy, the assumption that additional investment should be predicated on the money already spent. The second is just inadequate. Emily Dickinson, a wonderful poet, described hope as "the thing with feathers,"[68] but it is a terrible business strategy because it sets no course of action, no assessment of risks, and no accountability.

Beyond that, value creation requires a constant and careful attention to both the details and the large picture. Venture capitalists must constantly shift from matters of strategy to the details of the company's financials, without getting in the way of the company's daily operations. When the company under-performs, the venture capitalist should be immediately and closely involved. When it is meeting or exceeding milestones, the entrepreneur can have more autonomy—because she has earned it.

The best practices outlined in this paper were drawn from academic research and the firsthand experiences of fund managers. They can guide fund managers in generating value in their portfolios and in communicating the value creation process to LPs. Recognizing that each VC firm (and in fact each VC investment) is unique, we encourage LAC fund managers to contemplate these practices and adapt the best ones to fit their needs and the needs of their portfolios.

[68] Emily Dickinson, "Hope is the thing with feathers," Number 314.

Below is a list of best practices distilled from the text and divided into two sections: those practices internal to VC firms, and those practices related to firms' external dealings with portfolio companies.

Internal Best Practices

1. *Define Your Playing Field.* VC firms should approach investments with a clear understanding of their unique investment philosophy. They should have detailed knowledge of the regions, industries, and company stages they invest in. This should be informed by their internal strengths and expertise. Fund managers should not be tempted into "hot" sectors where they lack expertise. When funds stray into trendy sectors, the risk is far greater than the reward: success is expected, while failure brings the firm's entire decision-making process into question.

2. *Establish Roles and Processes.* The investment teams should clearly delineate internal roles and responsibilities. Each deal should be assigned a "champion" to spearhead it from due diligence to exit, ensuring consistency and accountability throughout the investment. Fund managers should regularly socialize deals through every stage of the investment. Communicating frequently and sharing information on one's investments with colleagues accesses "the wisdom of the partnership" and reduces the chances that the investment team will overlook important factors or repeat past mistakes.

3. *Do Not Fall in Love with the Deal, the Entrepreneur, or the Sector*. Due diligence should be exhausting, regardless of whether someone in the team knows the entrepreneur, or he/she comes highly recommended by someone close to the management team, or has had previous successes. It pays off to be highly skeptical in the beginning.

4. *Enter with Your Eyes on the Exit.* VC firms must consider possible exit routes from the initial due diligence until the exit is executed. Fund managers should consider exit routes when negotiating deals, and take steps during the investments' life to make portfolio companies more attractive for exit opportunities.

5. *Create a Strong Team that will Stay throughout the Fund's Life*. While there is no assurance that the whole team will stay throughout the fund's life, creating strong alignment and incentives, such as the fund manager's contribution to the fund and vesting of the carried interest, ensures better deal performance. A fund that suffers staff departures at any level loses important institutional memory and weakens the confidence of LPs and the relationships with entrepreneurs.

6. *Have an Active, Informed, and Engaged IC.* This practice applies to all fund managers, as it is easy not to ask the "hard questions" of a deal in the interests of

good relationships. In LAC the industry is young enough that another dynamic can complicate intra-firm relations: the addition of independent members to the IC who add value through their sector or operating expertise. The fund manager, however, must determine the best way to align these independent members and keep them interested throughout the fund's life, encouraging them to be active, value-adding members of the team. This concerns also applies to the LP Advisory Committee if a fund manager chooses to have one.

External Best Practices

7. *Know Thy Entrepreneur.* Fund managers should thoroughly vet entrepreneurs before making investments. It is important to have deep knowledge of their strengths and weaknesses. It is especially important to investigate their character. Fund managers must be confident that their entrepreneurs will exhibit good partnership behavior.

8. *Structure Deals that Protect Your Position.* Fund managers should negotiate deals that allow them to influence the success of the company. Investments should be tranched and linked to milestones. Fund managers should use preferred stock whenever possible, although some underdeveloped regions may benefit from using quasi-equity as an entry point to the relationship with the entrepreneur. VC firms should legally protect their control rights when negotiating deals and consider the legal framework of the countries in which portfolio companies are domiciled.

9. *Guard Your Reputation.* Fund managers must consider the consequences of their actions on their firm's reputation. The youth of the VC industry in LAC lends itself to misinterpretation by outsiders. Fund managers should strive to thoroughly explain the nature of VC investments to entrepreneurs before finalizing deals, maintain amicable relationships with portfolio company management, and always act responsibly to protect the reputations of their firms and themselves. The more protective clauses the fund managers include in their contracts, the more careful they must be to ensure that the entrepreneur understands the true nature and implications of the agreement. Non--defamation clauses are also recommended to protect the fund managers in case stringent measures are required to seize control of the company.

Creating value in LAC portfolio companies is difficult—but it is difficult for fund managers everywhere. Many venture capitalists have already successfully generated and realized value in their investments, despite the numerous challenges they confront. These current obstacles will likely subside as the LAC VC/PE industry grows, entrepreneurs become more familiar with the benefits and challenges of active investors, and local governments continue to adopt more VC/PE-friendly policies. VC firms should continue to reflect on their experiences, generating and sharing lessons that respond to the shifting challenges of the region. As current first-time fund managers grow in experience and expertise, they will help bolster LPs' positive sentiments toward LAC. The special attention that fund managers have given to creating value in their companies speaks to the care and thoughtfulness that they bring to investments and their dedication to developing a thriving regional VC industry.

Appendix 1: Business Development Skills Matrix

	Planning	Management	Finance	Marketing	Operations	Human Resources	Product Development
Seed	business concept, building the business plan (including market research), assessing viability	must be a visionary, self-starter/motivated, some business acumen	financial plan (if necessary), personal financing, professional services	networking, relationship building	too early	define skill set	define product
Start-Up	business plan evolution, measure, evaluate, modify	leader with broad business skills	start-up capital, detailed financial plan (if necessary)	marketing plan and implementation, beta-testing	infrastructure, processes/procedu res	skill requirements, how to recruit, government requirements/ policies	refining/ modifying, beta-testing
Early Stage	measure, evaluate, modify (market feedback), priorities: marketing and financing	formal, well-heeled board/advisors, key position: sales/marketing	working capital, access to capital, private investors	implementation, initial market penetration, market intelligence	consistency in product delivery, improve quality, infrastructure development	"fighting fires" scenario, team effort, employee loyalty, key task: recruiting,	final refinement, development of next generation
Late Stage	diversify product/services	more professional managers, key position: financials	venture capitalists, bank debt	consolidate position, increase market share, investigate new markets/products	higher volume, formalize systems and processes	"maintenance," functional responsibilities, key task: training/upgrading	incorporate customer feedback, modify/change products
Growth	realize market opportunities, growth as soon as possible	professional CEO (entrepreneur can fill role or take different role if more technical expertise)	professional CFO, more sophisticated finance, whole spectrum of capital (VC equity, etc.)	new markets and products	geographical spread including distribution and sales	"prevention," mature delineation of roles responsibilities, key tasks: structuring, planning, developing	more sophisticated level of incorporating customer feedback and modifying/ changing products

Adapted From: Industry Canada, "Management Skills for Small Business: Stages of Development and Their Differing Skills Needs," Fig. 6, May 7, 2012, available at https://www.ic.gc.ca/eic/site/061.nsf/eng/rd00406.html

Appendix 2: LAVCA 2013 Scorecard, 2014 Update (100 is highest)

2013 Scorecard | 2014 UPDATE	Argentina	Brazil	Chile	Colombia	Costa Rica	Dominican Republic	El Salvador	Mexico	Panama	Peru	Trinidad & Tobago	Uruguay	Israel	Spain	Taiwan	UK
Overall score*	**42**	**72**	**76**	**61**	**56**	**42**	**39**	**67**	**49**	**51**	**57**	**57**	**81**	**76**	**64**	**96**
Laws on PE/VC fund formation and operation	1	4	3	3	2	2	0	2	2	2	2	2	4	3	4	4
Tax treatment of PE/VC 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 local institutional investors investing in PE/VC	0	3	3	3	1	1	1	3	2	3	2	2	4	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	1	1	1	1	1	1	3	3	3	2	3
Quality of local accounting/use of international standards	4	4	4	2	4	3	3	3	2	4	3	3	4	4	3	4
Entrepreneurship	3	3	3	3	2	2	2	3	1	2	2	2	3	2	4	4

*Overall scores are unchanged from the eighth edition released in 2013

Source: Latin American Private Equity and Venture Capital Association, LAVCA 2013 Scorecard, 2014 Update: The Private Equity and Venture Capital Environment in Latin America, May 29, 2014, p. 4, http://lavca.org/2014/05/29/2013-lavca-scorecard-2014-update/.

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