

Multilateral Investment Fund-TC Profile

I. Basic Project Data

Country/Region:	Brazil
Program Name/Number:	Novarum Seed Investment Fund for Technology-based companies in Brazil, BR-M1031
Team Leader/Members:	Susana García-Robles (MIF/INV), Team Leader; Rogerio Ramos (MIF/INV), Antonio Gaspar (MIF/DEU), and XXX (LEG).
Date of Request:	October 2005
Beneficiary:	Brazilian technology-based start-ups
Executing Agency:	Jardim Botanico Partners
Financing Plan:	Technical Assistance: MIF (IIIA) up to USD 60,000
	Fund's Capitalization: ¹
	MIF IIIB USD 2,000,000
	Private investors USD 1,988,382
	FINEP 1 st tranche USD 893,655
	FINEP 2 nd tranche <u>USD 1,787,310²</u>
	Total USD 6,669,347
Technical and Basic Responsibility:	MIF Investment Unit
Classification:	SMF Tech
Tentative Dates:	POC and CESI October 2005
	IIC November 2005
	Donors December 14, 2005

II. Background and Problem Statement

A. Current State of the Private Equity, Venture Capital and Seed Financing in Brazil

- 2.01 Brazil has seen a significant growth in private equity activity (PE) in the last 10 years. There have been more than 50 different groups of investors looking for opportunities in all segments of the Brazilian economy, which has caused a deeper understanding of the implications and contributions of PE investment. In spite of the industry still needing to consolidate, Brazil has established a market for PE investing.
- 2.02 The boom in technology and Internet investments favored investing in venture capital (VC) for a very short period of time. The collapse of the market in 2001/2002 slowed this level of VC activity in Brazil, as well as investors' interest on it. To date, there is still a significant amount of capital allocated to larger companies, with SMEs finding it hard to receive long-term financing to accelerate their growth and compete against other incumbent players.

¹ Exchange rate as of 10/11/2005: USD 1= R\$ 2.238

² This tranche will only happen if the MIF invests in the fund.

- 2.03 When it comes to financing allocated for seed projects, the numbers are negligible. Brazil counts with a good number of incubators, which have been successful in both identifying and developing new technologies, and in giving opportunities to entrepreneurs. However when there is a need to make the transition from the incubation to operational stages, there is not enough capital available in the market to finance that. The consequences of having the “financing chain” broken are extremely negative as it means that: (i) there are hardly any growth opportunities for those dynamic companies which, despite having a proven technology, do not have the resources required to turn that technology into viable businesses; (ii) later investment vehicles such as VC and PE funds do not find enough good investment opportunities; and (iii) the motivational message sent is negative as it discourages entrepreneurs to pursue their ventures.
- 2.04 Brazil has enjoyed a very strong 2004-2005 economic performance, which is attracting overseas investors back to the country. Still, few consider investing in seed capital an option for their portfolio diversification. While the MIF has made strides in bringing pension funds into the VC industry, it is not likely that pension funds will develop an appetite for this segment of the industry typically funded by angel investors, government agencies, and multilaterals.

B. MIF’s Presence in Brazil and the INOVAR Partnership³

- 2.05 In Brazil, the MIF has been unquestionably one of the main actors through its presence in the VC funds and its participation in the INOVAR Program (MIF/AT-394)⁴. Throughout the last 5 years, MIF has been involved in this program, participating in Calls for Proposals and selecting with the other INOVAR Technology Investment Facility (TIF) members, a few funds for due diligence. As the program matured, new initiatives were incorporated. In 2004 INOVAR saw the importance of fostering the creation of seed funds along with more mature VC funds, and expanded the Call for Proposals to include seed funds’ proposals. Novarum was one of four funds (three were seed funds) selected out of 12 proposals presented during the 5th Call in July 2004. FINEP approved the investment in October 2004.
- 2.06 *Justification for MIF’s investment in this fund.* As part of the process of establishing the VC industry, investing in seed funds has not been yet explored by the MIF in Brazil, and is proving very necessary. MIF’s main objective is to provide funding to cover the financial gap in the industry where capital to finance companies from the incubation stage into operational business is scarce. MIF has learned from the pool of VC funds in Brazil, including the ones that have made seed investments (i.e. Fundotec) that not only there is a demand for seed capital, but also in many cases companies that reach VC stage are already under funded, which imply a greater number of VC financing rounds.
- 2.07 MIF’s additionality is to help strengthening the seed financing sector in Brazil, which in turn will both increase the number of viable projects to be funded in later stages by VC and PE funds, and provide these pre-operational companies with better capital structure.

³ Evaluation of MIF Projects: development of venture capital. Office of Evaluation and Oversight. MIF/GN-78-11 and Annex III.

⁴ Idem, Annex III, page 5.

In addition FINEP, BNDES, and SEBRAE have been considering, for some time now, starting a Seed Program, which would aim at creating some 30 seed funds in three years, each with the same capital and similar conditions, attempting to standardize the seed investing process. The MIF has been invited to join this initiative, but first would prefer to invest in a few funds of this type and gather some lessons learned, before considering participating in this bigger program.

- 2.08 The participation of MIF in Novarum will improve the fund capitalization allowing the fund to invest in more companies, thus improving the diversification of the fund, and building a pipeline of competitive companies to be funded at later stage by VC funds. In addition, MIF's investment in this fund would signal to the market its confidence in Jardim Botânico Partners (JB). The creation of solid, local fund management companies has been one of the many results of the INOVAR Program to date, and one that ensures the sustainability of the industry.

III. Program Objective and Description

- 3.1 The project consists of the creation of a VC fund exclusively devoted to investing seed capital in technology-based companies in Brazil. The objectives of the project are: 1) filling in the financing gap this segment suffers from, which in turn will help the more mature stages of VC; 2) to help entrepreneurs to take their companies into commercial operation; and 3) to provide a source of financing to new technologies developed through scientific research in different Brazilian Research Centers and Universities.
- 3.2 Expected results. With our investment, FINEP will allocate an additional R\$ 4.1 mm (USD 1,831,992) into this fund, allowing it to reach a more competitive size, and to invest in 7 to 10 companies. The fund intends to fill a financing gap for seed companies in Brazil that have a high potential for growth but that currently have no access to long term financing, providing a bridge between entrepreneurs developing new technologies and strategic investors; helping the former commercialize their products. The strategy of the Fund and the skills of the management team will contribute to the development of these seed companies that may serve as an example of how seed capital is the first step towards the strengthening of the venture capital cycle.
- 3.3 Investment Strategy. The Fund will invest an amount between R\$ 400 thousand to R\$ 1 mm in seed companies for a minority stake between 20% and 49%. The Fund will focus on technology-based innovative companies, mainly in the segments of Telecom/IT, New Material Development, Biotechnology, Agribusiness, Ecobusiness, and Ecoenergy. The fund also intends to leave a reserve to provide follow-on investments to some of the portfolio companies as needed. This is very much in line with the experience acquired by the MIF in its 10 years of VC investing: even successful SMEs are always in need of more cash, and our funds' evaluations have shown that the fund managers could have used second rounds of financing in the best companies, to increase their upside, after having taken a high risk, usually providing the first round of equity financing. The Fund plans to create value by taking a very active "hands-on" role in the strategic and financial direction of its portfolio companies.

- 3.4 Diversification. The Fund plans to invest up to 15% of its capital in each portfolio company, and no more than 50% in any given sector. Novarum expects the majority of the investment to be on IT and Biotech, and to a lesser extent in the remaining targeted sectors. The Fund may seek to co-invest with other local or strategic investors when the investment needed exceeds the financing the Fund can provide. Although the fund can invest throughout Brazil, it will most likely concentrate operations in Southeastern Brazil.
- 3.5 Compensation. The Fund has been designed to include an annual fee to the administrator of 3.0% of the aggregate capital commitments during the first three years of the investment period, and 3.0% of the managed assets thereafter, plus a 25% carried interest, only payable to the manager after investors have received the initial capital plus a preferred return of IGP-M (Fundacao Getulio Vargas inflation adjusted index) + 12% p.a.
- 3.6 Structure. The Fund will have an Investment Period of three years and a life of six years, with a three-year extension possible. The governance structure will be composed of a General Assembly (GA) of Shareholders and an Investment Committee (IC) of up to seven members, depending on the final structure of the investors group. The most important members in the IC of a seed fund are the angel investors, which add knowledge to the process. Therefore, the MIF will have a predominant role in the General Assembly, but most likely will be an observer in the IC, always ensuring to have leverage on important issues through the GA.

IV. Cost and Financing

- 4.1 The Fund has already started operations with a minimum capitalization of R\$ 6.45 mm (approx. USD 2,882,037mm⁵) raised through individual private investors (R\$ 3.45 mm), private corporations (R\$ 1 mm), and FINEP. FINEP's commitment to Novarum will go up to R\$ 6 mm (30% of the fund) if the MIF invests. The Fund expects the total capitalization to be in the amount of R\$15 million to R\$20 million (USD 6,702,412 mm to USD 8,936,550 mm). Given the developmental nature of the fund, and the fact that they have already raised a substantial amount from the private sector, the MIF will not be applying a 1:1 *pari passu* with private investment at the time of its entrance in the fund.
- 4.2 The Fund will be submitted to two independent evaluations to be financed by MIF. MIF will allocate USD 60,000 from its Facility III-A, to perform these evaluations during the life of the fund. The evaluations will consider the financial performance of the fund, the types of deals in the portfolio, the overall operational functioning of the fund manager, as well as the social and environmental impact of the fund's investments. The MIF will select the firm or individual to perform the evaluations, and will directly disburse the money to pay for these from Headquarters.

V. Executing Agency

- 5.1 The administrator of the Fund is *Jardim Botânico Partners Investimentos LTDA (JB)*, an investment boutique founded in 2003 by former *Comissão de Valores Mobiliários*

⁵ Exchange rate as of 10/11/2005: USD 1= R\$ 2.238

(CVM)'s president Jose Luiz Osório. JB is a dedicated and specialized asset management company focused on Alternative Assets in Brazil. The group has concentrated its business on seed, VC, mezzanine, and late stage PE financing. JB is a rather new management company but, through its partners, has a collective experience on M&A, equity research, fund management, venture capital and private equity investments, securities regulation, legal diligence and investment banking.

- 5.2 Track record. Jardim Botânico currently has two funds under management: Novarum and Travessia, a R\$ 26 mm mezzanine fund for emerging companies. Since the firm was recently established and both funds have just started to operate, JB has not established a track record yet. However, the experience of its Management Team, combined with the support and investment by 23 private individual investors, one institutional investor, and one corporate investor, sends a strong message about the confidence the market has on the team's competence.
- 5.3 As of October 2005, Novarum's Investment Committee approved two investments and the Fund has already committed R\$ 400,000 for a 25% stake in *CommunIP*, a voice over IP service provider. The other investment approved was a R\$ 600,000 investment in *Ecover*, a company that provides vaccines against tropical diseases. The investment was not consummated after a non-favorable technical report provided to the Management Company. Currently Novarum has 31 projects in the pipeline, of which 7 have been closely monitored for potential investments.
- 5.4 In addition to Novarum and Travessia, Jardim Botânico Partners have also two funds in fund raising stage. The first fund will target medium-sized companies in expansion. The other fund is the former DVCII, now called JBVCI, in which MIF approved an investment of USD 4 mm last November 2004. In the beginning of 2005, Dynamo took the strategic decision to leave the VC sector to focus on PE exclusively; and therefore investors which had approved DVCII, including the MIF, performed a due diligence on JB to decide if they would consider keeping their commitment in the fund, passing the management over to JB Partners. The decision was affirmative, and JB is completing capitalization for this fund now.
- 5.5 Jardim Botânico has offices in both Rio de Janeiro and Belo Horizonte. This fund will be managed by the Belo Horizonte's offices, although it will have some collaboration from the Rio office, including participation in the IC. The Management Team is composed by Mr. Levindo Santos, JB Managing Partner, former manager director of Morgan Stanley (1996-2002), and with experience in investments in private and public companies, mergers & acquisitions, and fund management; Ricardo Oliveira, Associate with a BS in Veterinary Medicine and a former IT consultant for Brazilian SMEs (agribusinesses); and Bruno Borges (BS in Biology and a BS in Production Engineering in progress) as Analyst.
- 5.6 Jardim Botânico will also count with the contribution of key members of the IC, such as Jose Luiz Osorio, VP of the Brazilian Institute for Corporate Governance and former president of the Brazilian regulatory agency CVM, and Evaldo Fontes Jr, who worked as a legal and strategic consultant for many Brazilian SMEs.

5.7 Jardim Botânico has been able to develop a reasonable networking, including individuals and companies, to help support the development of the Novarum Fund and of its portfolio companies.

5.8 The INOVAR TIF members rated Novarum in the following manner:

Strengths	Weaknesses
The team is aligned with the fund's objectives	Lack of track record in the industry
Proven track record in attracting angel investment	
Team members have had previous experience on the industry	
Good network in Brazil and overseas	
Capitalization is already achieved	

VI. Major issues

6.1 The MIF already participated in the due diligence performed on this fund with the other INOVAR partners a year ago. At the time, the MIF decided not to pursue this fund given that there were other Brazilian funds in the pipeline already. Nonetheless, the MIF has kept constant communication with FINEP and the fund managers, receiving updates on the fund's activities and being invited to participate in the IC as observer. FINEP's feedback on the fund manager's performance is very satisfactory. Although the fund recently invested in a company, there would not be valuation issues to consider if the MIF were to invest in the near future in this fund. The fund is at present regulated by the CVM 391, which poses some difficulties for the MIF to enter as an investor. All the Novarum shareholders have already manifested their willingness to approve the fund's migration to the CVM 209, in order to allow for an easy entry in the fund by MIF.

VII. Environment & Social Issues

7.1 The team did not identify ex-ante any negative environmental impact. However, the Novarum's investees will have to practice sound labor and hiring practices, and JB will manage the fund in accordance with the IDB/MIF environmental and social guidelines for MIF Financial Intermediary Operations⁶. As part of fulfilling the requirements of these guidelines, the Novarum managers will be expected to participate in a MIF/IDB approved training course on environmental and social review for financial intermediaries and elaborate a social environmental management system for the fund, based on the MIF manual for social and environmental monitoring and due diligence for financial intermediaries. Consistent with Brazilian law, the fund manager will not discriminate in the selection of investments along gender lines or ethnic origin. The analysis on potential negative environmental impacts and alternative solutions will be part of the fund manager's investment proposal when presenting a company for approval by the IC.

⁶ <http://www.iadb.org/mif/v2/envsocguidelines.html>