MIF Equity Investment Profile

Country: Brazil

December 1, 2000

Project Name: Remittance Fund for Entrepreneurs (*Dekassegui* Fund).

Project Number: TC-00-04-002

Fund Manager: Banco do Brasil and Banco Fator

Financing: Equity Investment

MIF	US$ 5,000,000
SEBRAE	US$ 4,500,000
Fund Management Company	US$ 500,000
Remittance	US$ 2,000,000
Total	US$ 12,000,000

1. Country and Project Eligibility

1.1 On February 9, 1995, the Donors Committee declared Brazil eligible to receive financing from the Multilateral Investment Fund under all modalities available.

1.2 The proposed project is fully consistent with the general purpose of the MIF to stimulate small enterprise development, and with the eligibility criteria for the Small Enterprise Investment Fund of the MIF. The project is also compatible with the current MIF strategy, particularly because the MIF resources: 1) open opportunities for entrepreneurs by providing risk capital and management skills; and 2) supply vital market access to expand start-up and/or small businesses. The project will enhance the productivity of the private sector, thus accelerating economic growth.

2. Background

2.1 Due in large part to the economic downturns Brazil has suffered, many Brazilians have emigrated, if only temporarily, in order to earn more elsewhere. A significant number of these have moved to Japan to work. According to Japan's Justice Ministry there are 222,217 Brazilians living and working in Japan. They are the third largest group of Brazilian exiles after the United States and Paraguay. Primarily these are *nisei* and *sansei* (second and third generation Japanese), the children and grandchildren of the Japanese who moved to Brazil as early as 1908 when the Kasatu Maru ship took the first immigrants. As with most of the migrants, the *dekassegui* – a Japanese term which means to leave to make money – moved to improve their economic lot.

2.2 The Brazilian *dekassegui* phenomenon started at the end of the 1980s, after a period of slow growth in Brazil. Then with the deteriorating Japanese economy, many *dekassegui* returned to Brazil. However, in 1999, following the devaluation of the Real, a new cycle started as the Japanese economy again picked up steam. Ads asking for *nisei* and *sansei* to work in Japan are once again common in Japanese newspapers published in Brazil. Monthly salaries are on average around $3,500 for men and $3,000 for women. *Dekassegui* are often found in jobs such as manual labor and factory work that native-born Japanese seldom do themselves, and for which the *dekassegui* almost invariably middle-class, and frequently college graduates, are overqualified.

However, the salaries are the great attraction of working in Japan. Even taking into consideration the higher cost of living in Japan, many *dekassegui* can save much more than they could back home.

2.3 Most Brazilian migrants in Japan are temporary workers and intend on returning to Brazil, while some become successful and settle in Japan. In general, though, the average number of years that the *dekasegui* stay in Japan is three to five years. As the temporary workers save money, they send it back home or buy consumables in Japan. Of the remittances, the majority goes to consumables, while some is saved for homes or new businesses. On average, it is said that *dekassegui* save $50,000-$70,000 while working abroad for an average of three years (their savings rate is very high, equaling approximately 40% of disposable income). Overall annual remittances amount to approximately $1.5 billion.

2.4 In very broad terms, the *dekassegui* can be categorized in one of two ways: a) 70% have gone to Japan to look for jobs with higher salaries and are hoping to save money to repay debt; b) 30% are young with college degrees or entrepreneurial experience and are interested in obtaining hands-on experience which they can apply to their own businesses when they return to Brazil. The latter is the main target of the proposed Fund. Approximately 60% of the returning dekassegui are residents of the state of Sao Paulo, followed by 25% from Parana and 5% from Mato Grosso do Sul. According to a market study based on interviews and meetings with approximately 100 returning *dekassegui*, the types of business they are interested in starting include agribusiness, e-commerce, export/import business, retail and hardware/construction materials.

2.5 More than 75% of the returning *dekassegui* (an estimated 30,000 *dekassegui* return to Brazil annually) are actively engaged in starting new businesses or expanding their existing small businesses. Some of them receive support from their relatives and friends, as their own saved resources are not enough. They usually form small groups of association of mutual help. The objective of such groups is to share the members´ experience in Japan and develop solidarity among members though an exchange of information on market development. For example, Grupo Okinawa of Sao Paulo City represents a successful case of such a group. It was founded 10 yeas ago by young entrepreneurs as an "informal brotherhood" to help each other to overcome the difficulties involved in running small firms. Currently the group is composed of 99 members ; most of them are former-*dekassegui* and each one owns a small, but financially sustainable business of electronic parts, hardware and construction materials. The group has a plan to launch a new franchising business and has raised US$500,000 of their own capital, but needs more capital as well as financial advisory services.

2.6 There are dozens of joint efforts by similar groups of *dekassegui* in other locations. One, for example, has formed a holding company to incubate new businesses (to take an equity position in exchange for business advisory services), while another has formed a cooperative to export medical herbs and flowers. Another group has started a for-profit industrial condominium to house foreign investments in a Silicon Valley-like setting of San Jose dos Campos. These initiatives have been made possible thanks to the extensive networking of the Japanese-origin communities with regard to production, industrialization, transport and marketing.

3. Project Objectives, Justification and Benefits

3.1 The objective of the Brazilian Remittance Fund project is to promote entrepreneurial activities by those Brazilian temporary workers overseas who desire to start businesses upon their return to Brazil. The project also intends to create a mechanism to tap into the regularly transferred

remittance accounts described above, and direct a small portion of the funds to more productive uses.

3.2 Brazilian temporary workers are prepared and motivated to start new businesses, using their earned "bootstrap" money and experiences and/or networks established while working in Japan. Due to lack of enough seed capital for start-up or small-size business development, however, they have been unable to follow through on their plans. The target remittances to be tapped are those flowing from Japan to Brazil; these make up a large, constant stream of funds that can be targeted through a financial institution such as Banco do Brasil. Nevertheless, the project <u>does not exclude</u> those Brazilians who have temporarily emigrated to countries other than Japan to work, who would like to return to Brazil to start up businesses.

3.3 The creation of a Remittance Fund would serve three primary purposes: 1) it would foment the development of small businesses; 2) it would channel existing savings into productive uses; and 3) it would support returning *dekassegui* in starting new businesses. In addition, the Fund will promote job creation, entrepreneurship and a socially responsible investment culture. To a lesser extent the project will contribute to local capital market development.

3.4 *Small business development*: In Brazil, as in countries around the world, small businesses provide employment, flexibility in the face of a changing market, innovation, and a basis for economic growth. Nevertheless, they have difficulty accessing necessary financing to start up operations. In general, local financial institutions do not provide financing to the SME sector. The system is still suffering from an "inflation hangover" and the broader capital markets have not adjusted to a longer-term mentality. Also retarding development of term lending is the fact that many banking sectors in the region are still undergoing reform as a result of market liberalization and competition entering from abroad. Privatization of public sector banks is very active and foreign players are setting up their own ventures and acquiring banks. Many of these new participants bring with them the benefits of technology and another capabilities new to the market. Nevertheless, despite progress observed in domestic financial intermediation in the region, the financial market does not see small business as a target market with interesting advantages.

3.5 There are entrenched problems related to high costs of transactions and risks associated with lenders to small businesses who have difficulty in presenting the collateral required by the financial sector. Supply of "listable" companies to the public equity markets is limited, due in part to a predominance of family controlled corporations that cannot make the institutional jump involved in meeting listing and reporting requirements. Although small businesses in general are flexible to the dynamic changes of the economy, they are faced with other problems related to the implicit costs of "formalization" of their businesses which makes them reluctant to seek access to the capital markets. Until long-term funds are available from other sources, the small business sector must be supported by risk capital which, in addition to capital, provides direct and long-term technical assistance through the investors' participation in management decisions.

3.6 Although the equity financing they provide helps firms grow, an important part of the value–added and development impact of risk capital funds is the expertise in strategic/financial planning, marketing and accessing complementary financing that they bring to their investee firms. A Remittance Fund in Brazil would provide such expertise to small businesses, a sector that is in need of such technical input. Indeed, as is discussed later, because of its focus on supporting a broad spectrum of start-up businesses with both capital and advice, the Remittance Fund can be viewed as a development fund as much as a venture capital fund.

3.7 *Channel Savings*: Currently**,** temporary workers in Japan are sending approximately $1.5 billion back to Brazil per year. The majority of this is used for consumables rather than for productive uses. Of that which is saved to start businesses, the amounts saved are often not enough to successfully start up and sustain an enterprise. Creating a fund that would tap into the remittances and would invest in start-up small businesses will strengthen the Brazilian economy by applying a productive use multiplier to the original savings.

3.8 *Supporting Dekassegui as entrepreneurs*: Many of the temporary workers in Japan are saving money to start businesses of their own upon their return to Brazil. However, generally speaking, the amounts they save are not enough on their own to support the start-up of a new venture. A Remittance Fund that targets start-up companies of *dekassegui* would support these returning workers.

3.9 *Job Creation*: By supporting the expansion of small companies, the Project will contribute to job creation within those enterprises as well as within up-stream supplier companies.

3.10 *Demonstration effect:* The Project's focus will significantly emphasize start-up companies, a niche under-served by the few equity capital investment funds already established in the region. The Fund will strive to involve local capital providers in their investments, thus providing them broader exposure to and comfort with this segment. A private equity fund is one of the few viable approaches to mobilizing capital to help entrepreneurs start and expand smaller businesses. The Fund's investments are intended to be models for successful venture financing. The Project intends to lead the movement to meet the increasing demands for capital from its target industries. In doing so, it aims to help overcome an insufficiency of institutional investment capital in the region. Furthermore, if the Remittance Fund proves successful in Brazil, similar Funds could be established elsewhere in Latin America.

3.11 *Capital Markets Development*: The Remittance Fund's exit strategies will include sales to third party institutional investors who otherwise would not target this market. This will open financing possibilities to other small enterprises and will improve market efficiency. In appropriate cases, initial public offerings will be used as the exit strategy, thereby contributing to the widening and deepening of local capital markets, and encouraging the process of capital formation and promoting the creation of investment instruments.

4. Project Components and Structure

4.1 The project under consideration consists of an equity investment of US$5 million by MIF in a US$12 million fund which in turn invests in new and/or small companies in Brazil.

4.2 The Fund will be formed as a special-purpose vehicle (SPV) for investing in start-up companies in Brazil, particularly those founded by returning *dekassegui*. The only eligibility criterion for receiving capital from the Fund is that investee companies should be funded by at least one partner who has worked as *dekassegui* or worked overseas to the same effect. The Fund will seek to acquire minority holdings that are of sufficient import to each entity to enable it to influence, via board membership, the activities of the entity concerned and to give local management technical guidance. The Fund will additionally provide expertise and advice to the invested companies by means of board participation and lessons of experience from other markets.

4.3 The initial committed capital is US$10 million; however, immediately after the initial capital is raised, the Fund will start offering "special equity securities" to Brazilian temporary and quasi-permanent workers in Japan. The project anticipates raising US$2 million through the issuance of

the equity securities to the *dekassegui* (see 4.5 and 4.6). Thus, the Fund's first closing goal is US$12 million including the amount tapped from the remittances. The Fund will have a ten-year-term, and individual investments will have four to five year terms. Exit strategies will include private equity sales to third party investors, put options, and initial public offerings on the local securities exchange.

4.4 The Fund will seek to achieve medium-to long-term capital appreciation of its portfolio by investing in approximately 40 start-ups/small businesses over its 10-year life at an average amount of US$250,000 with a tenure of 4-5 years. Although making smaller investments in a large number of companies can be administratively burdensome, it serves to diversify risk and to assist more *dekassegui* with their goals of starting up businesses, thereby creating more jobs and channeling more savings into productive uses. Fewer but larger investments can be a risky strategy given the early development stage of potential investees (see 6.3).

4.5 As discussed above, *dekassegui* and quasi-permanent Brazilian residents in Japan would be invited to purchase a special equity instrument that would issue a fixed 7% dividend annually, and would also allow the holders to receive a portion of the capital gains distributions (5% of net realized gains) resulting from exiting investments. 1 The instrument would take the basic form of partially participating cumulative preferred stock with a call option after 10 years**.** 2 To mitigate a potential problem of liquidity for compensating the preferred stock, in appropriate circumstances, the Fund may also invest up to 20% of the total value of the Fund in securities offering high current yield in order to maintain a measure of liquidity.

4.6 Meanwhile, MIF and SEBRAE would receive limited partnership interests granting them voting rights, a 7% hurdle rate, and 75% of distributions in excess of the hurdle rate (following 100% capital redemption). Banco do Brasil will market the preferred stock, through its branch in Tokyo, to its *dekassegui* and quasi-permanent Brazilian clients.

4.7 The expected amount raised from *dekassegui* and quasi-permanent Brazilian residents will be US$2 million. This figure is well within reach, given that annual remittances from Japan to Brazil amount to approximately US$1.5 billion and that Banco do Brasil currently captures US$400 million of these remittances. US$2 million would constitute only 0.5% of the funds Banco do Brasil handles. Banco do Brasil has undertaken a preliminary informal survey of those clients who represent potential investors and has committed to marketing the new product, making full use of its broad customer base and well-established Japanese network.

4.8 **Legal Structure**

The Fund will be established in a tax-efficient jurisdiction and have an operating life of 10 years. The Fund will reinvest earnings and the proceeds of equity sales for the first five years, except for

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1/. Brazilians savings deposited in Banco do Brasil's dollar-denominated accounts currently generate 5-5.5% in interest, and in recent history earned 6%. This can be considered their "opportunity cost."

2/. The non-voting preferred stock will receive annual dividends of 7%. If in any year, due to insufficient earnings or another cause, the preferred dividends are not paid, they will accumulate until paid out; the preferred dividends must be paid out before dividends can be paid to common stockholders, or in this case the holders of limited partnership units. Generally speaking, in partially participating preferred stock, preferred stockholders participate in excess dividends over the preferred dividend rate proportionately with common stockholders up to a maximum rate; in this case, preferred stockholders will participate in 5% of the excess distributions above and beyond the preferred dividend and limited partnership hurdle rate.

annual dividends paid on the *dekassegui* preferred, following which excess earnings will be distributed as capital redemption and dividends. The Fund will be scheduled to be liquidated 10 years after commencement of operations. An effective liquidation mechanism will be included to purchase all of IDB/MIF's share after the ninth anniversary of the Fund, if and only if, a majority of investors decides at that time to extend the term of the Fund beyond its original ten year term.

4.9 **Terms of MIF Investment.**
MIF will acquire "common" shares (limited partnership units) up to the lesser of the US$ 5 million or 50% of the Fund´s aggregate capital commitment excluding special equity securities. Even in the case that the Fund fails to raise funds from the *dekassegui* and quasi-permanent Brazilian residents, MIF is committed to investing up to the above-referenced amount until a 50% share is obtained. In the case that the Fund raises more than US$ 2 million from *dekassegui*, the special equity securities offering will be capped at US$ 4 million, so as not to overly dilute MIF´s holdings.

5. Governance and Management

5.1 *Board of Directors and Investment Committee*
The Fund will have a Board of Directors designated by the principal shareholders. MIF will have the right to nominate its representative to the Board. The Board will be responsible for setting policy matters, appointing the investment Manager, establishing the annual budget and approving the selection criteria and investment approval process. It will also create an investment committee of the Board to provide oversight, review and approve investment proposals recommended by the Manager and to ensure that all projects meet the investment criteria. The selection and pre-approval of individual investments (which must conform to the investment criteria discussed) will be determined by the Manager, which will subsequently recommend investments to the Fund's Investment Committee for final approval. Members of the Investment Committee will be determined by the Board. MIF will have an option to nominate a member to the Investment Committee.

5.2 *Management Fee and Performance Incentive Fee*
The Fund will pay the Manager an annual management fee of 3.0% of the total committed capital to cover operating costs. The Manager will also receive a performance incentive tied to the Fund's realized gains. (20% on profits above 7% annual preferred dividend and the 7% limited partner hurdle rate). Under some circumstances, subject to the conditions described below (6.9), "extra" expenses will be charged to the Fund, provided they should not exceed 0.3% of the Fund's committed capital and will only be admitted during the first five years of investment period.

5.3 **Manager**
The Fund will be managed by a venture capital management company to be created through a joint venture between Banco do Brasil Distribuidora de Titulos e Valores Mobiliarios (BBDTVM) and Banco Fator Administracao de Recursos Ltda (FAR), both of which are specialized in asset management and private equity investment. The principal staff and consultants will be seasoned venture capitalists and business experts from a variety of markets and backgrounds; this will facilitate access to the information needed to assess the potential investee/start-up companies.

5.4 BBDTVM is a Rio de Janeiro-based wholly-owned subsidiary of Banco do Brasil, which is specialized in asset management. While BBDTVM´s participation is instrumental in terms of

channeling remittances and generating deal flow (see below), structuring, analyzing and monitoring the actual deals will be undertaken primarily by FAR´s staff.

5.5 BBDTVM has been handling more than 100 traded security investment funds, and has US$15 billion under management (equivalent to 15% of the total Brazilian market share). BBTDTVM has just launched an infrastructure fund -- BB Infra-estructura Nordeste (BBIN). The target capitalization of BBIN is US$75 million. BBIN is constituted as a "Carteira Livre" with a duration of seven years and is intended to generate a higher than average return mainly through privatizations and concessions in the North East. Investments made will be medium term, for participations between 20% and 40%, and will be for no less than R$7 million each. Exit strategies will include put options, sales to third party investors and public offerings. Although BBIN primarily targets infrastructure investments, the intended portfolio will contain other sectors as well; consequently, BBTVM is rapidly acquiring skills in structuring minority shareholding deals and helping the management of portfolio companies.

5.6 Banco Fator S.A. has 32 years experience in local and international capital market**s** and is one of the leading investment banks with expertise in providing specialized financial services including securities brokerage and M&A activities in domestic and international financial markets. It also has been very active in privatizations and business advisory services. In terms of underwriting activities, Banco Fator ranks among the five most active underwriters in the Brazilian market over the last 10 years. The total volume successfully placed in the market in 1998 was R$ 1.3 billion (US$ 760 million).

5.7 Fator Investment Research, the Bank's research arm specialized in technical, fundamental, and corporate analysis, covers 97 companies that represent 95% of the total market capitalization of the Brazilian Stock Market. For the past four years, it has been recognized by ABAMEC-Brazilian Association of Capital Markets Analysts and the IBMEC-Brazilian Capital Markets Institute as one of the best analysts in Brazil. As a member of BVESPA, SOMA, NASDAQ and NYSE, Fator Doria Atherino S.A. Corretora, the Bank's securities subsidiary, also has presented outstanding results both in the secondary domestic as well as international securities markets. The firm's transaction volume was R$5.5 billion (US$ 4.6 billion) in 1997, representing a 9% share of the market, and it ranked first among 129 broker dealers that operated in the CATS (that mainly covers second and third tier stocks) system in 1999. Meanwhile, Fator Projetos e Assesoria Ltda, making use of its synergy with Corretora, provides advisory services in the areas of privatization, concessions of public utilities, project finance, M&A and corporate restructuring.

5.8 FAR (Fator Administracao de Recursos Ltda), an asset management subsidiary, has R$1 billion (US$590 million) under management. The volume of transactions amounted to US$4.6 billion in 1997. Their clients include 200 institutional investor-pension funds, equity funds, banks and foreign investors. In 2000, FAR has started private equity fund management, and is managing a US$18 million fund sponsored by BANDES-Par. With four investments placed successfully in growing businesses, FAR is expected to be more aggressive in private equity management in the future.

6. Investment Policy and Characteristics of Development Fund

6.1 Investment Policy

Investee companies will be mainly start-ups that have been founded, if not entirely, or financially supported by returning *dekassegui* and those Brazilian temporary workers who spent several years overseas (See 4.2). The Fund aims to identify start-up companies that have adequate foresight and competent management to be able to achieve above-average results and growth by

providing them with the early stage financing and technical expertise necessary to ensure their successful beginning operations and to position them for sustainable growth and prosperity.

6.2 Industry focuses will include communications, e-business, and media, as well as more traditional industries such as agriculture, civil construction, steel, auto parts, etc. Investee companies will have sound business plans and strong management teams. Eligible companies (new or existing) will be Brazilian entrepreneur-owned, and have revenues of $3 million and under with less than 100 employees. The Fund will seek to achieve medium-to long-term capital appreciation of its portfolio investments; however, in appropriate circumstances, it may also invest up to 20% of the total value of the Fund in securities offering high current yield in order to maintain a measure of liquidity. The Fund will reinvest earnings and the proceeds of equity sales for the first five years, except for annual dividends paid on the *dekassegui* preferred, following which excess earnings will be distributed as capital redemption and dividends. As there are annual preferred dividend payments to *dekassegui* investors, the estimated total invested amount is projected to be less than US$12 million.

6.3 **Development Fund Model for Early-Stage Financing**

As venture capital is still new to the Brazilian market, and the objective of this project is to promote entrepreneurial activities by returning *dekassegui* (many of whom have little proven business experience), the Fund will not follow a conventional venture capital fund model, but rather will act more as a development fund. Rather than relying on a few outstanding winners, the Fund will attempt to support a greater number of "medium return" deals that are more likely to have even performances and fewer write-offs. The primary focus will be on providing early-stage financing such as seed capital, start-up financing and first-stage financing. In a very few cases, the Fund may provide second-stage financing to *dekassegu*i-run small businesses. [3]

6.4 **Seed Capital Financing**

In keeping with the notion of the Fund being a development fund, rather than a straightforward venture capital fund, the Fund will not only provide start-up and first-stage (and in some cases second-stage) financing, but it will also provide seed capital in certain cases. This capital, as discussed above, would finance initial market research, product development and business plan development. The amount allotted to seed capital would be limited to a cumulative total of US$1 million. Up to US$50,000 would be invested in each of approximately 20 promising but very early stage entrepreneurial companies. These investments would be made by the Fund Manager at the rate of approximately four per year over the first five years of the Fund. It is expected that these companies would have great potential but would otherwise be at too early a stage of development for standard investments by the Fund.

6.5 For instance, they might be in the process of developing a prototype of a product or demonstrating a technique with market potential but not have proven the commercial viability of

[3]/ Financing Definitions: Seed financing is a relatively small amount of capital provided to an entrepreneur to prove a concept and to qualify for start-up capital. This may involve product development and market research as well as building a management team and developing a business plan, if the initial steps are successful. Start-up financing is provided to companies completing product development and initial marketing. Companies may be in the process of organizing or they may already be in business for one year or less, but have not sold their product commercially. Usually such firms will have made market studies, assembled the key management, developed a business plan, and are ready to do business. First-stage financing is provided to companies that have expended their initial capital (often in developing and market testing a prototype), and require funds to initiate full-scale manufacturing and sales. Second-stage financing is working capital for the initial expansion of a company that is producing and shipping, and has growing accounts receivable and inventories. Although the company has made progress, it may not yet be showing a profit.

the venture. Repayment of the investment capital of this nature would be arranged through a debt instrument that would require repayment to begin after a one-year grace period commencing on the date of the investment. It would be then structured that such repayment would be made monthly at a small percentage of revenues until a total of the amount of the original investment has been paid. In effect, the seed capital would be provided as a zero-interest loan, with no claim for the principal in case of default. The companies receiving such financing are likely to be candidates for start-up or first-stage investment from the Fund at a later date. In cases where the Fund in fact invests in the company at a later date, to the extent possible, the Fund manager may attempt to recoup some of the “lost interest” from the seed financing loan through receiving equity or quasi-equity shares equal to an agreed-upon value of forsaken interest.

6.6 Seed capital financing will greatly assist returning *dekassegui* in structuring their new business ideas and developing viable business plans. This feature of seed financing by the Fund will be advertised through the same channels used to market the *dekassegui* preferred stock; Banco do Brasil, which currently captures more than 30% of all remittances from Japan annually, will distribute to the *dekassegui* fliers and application materials for zero-interest seed financing loans.

6.7 Where appropriate, the Fund Manager will provide “hands-on” assistance to the management of these companies, through a structured program of small group sessions arranged with one or more technical assistance providers such as SEBRAE. SEBRAE has recently started various support programs for new business starters (not exclusively designed for *dekassegui)*. SEBRAE subsidizes initial training for selected entrepreneurs, including basic advice on how to draft business plans. However, more professional consultation on elaboration of business plans is needed. The proposed seed financing fund will be used for hiring specialized consultants to advise on more technical study and specific business plan elaboration, meanwhile SEBRAE provides, on a continuous basis, general support and augmentation of entrepreneurship through training programs.

6.8 *Incremental Due Diligence Cost*. The Fund will operate under investment guidelines that call for due diligence procedures typical of private equity funds. However, the due diligence costs associated with the large number of small deals processed by a development fund will likely be higher than the due diligence costs incurred by standard venture capital funds. To offset some of these costs, as described above (5.2), the Fund Manager may request that, when applying for start-up or early-stage financing, those companies that received zero-interest seed financing loans cover some expenses chargeable to the Fund. For example, in general, it is expected that most of the target *dekassegui* companies will have prepared sound business plans, but in some cases, the Fund manager may want to have the target firm undertake an additional study (technical, legal, accounting etc.) required for due diligence by the Fund; this study would be incorporated into the company’s business plan and would provide the Fund with the additional information it needed to make a sound investment decision. In these cases, the incremental due diligence might be covered as additional management expenses during the process of business plan refinement. The incremental due diligence, however, would be pursued only for a limited number of highly promising deals that, for lack of funds or experience, did not provide all of the information needed by the Fund manager to make a decision.

6.9 **Start-Up, First-Stage and Limited Second Stage Financing**

For the early-stage financing investments, the Fund will rely on financial instruments that provide capital appreciation and/or cumulative return. It is unlikely that there will be current return in most early stage investments, since the company’s cashflow (if any) will most often be dedicated toward funding future growth of the business. However, the structure may provide for a cumulative dividend on a convertible preferred stock, which will become part of the “liquidation

preference" upon sale or redemption. This has the effect of providing a minimum rate of return to the Fund on a priority basis before the common stock held by the entrepreneur and others will receive anything. For second-stage financings, where the company's projected cash flow is strong enough to provide some sort of current return, the structure may include a "current pay" dividend on preferred stock or current interest payments on a debt instrument. Even in these cases, however, the principal financial objective of the Fund will be capital appreciation of the equity securities associated with the investment.

6.10 Likely investment structures for early-stage invesments include (a) convertible preferred stock, which is convertible into common stock at the option of the Fund, or perhaps, mandatorily upon the occurrence of certain events (public offering, takeover, etc.); (b) a convertible note, which provides for conversion of the principal amount of the note into common stock at the option of the Fund, or perhaps, mandatorily upon the occurrence of certain events; (c) stock purchase warrants, issued in conjunction with promissory notes, giving the Fund the right to purchase common stock at a fixed price at some future date.

6.11 In limited cases, traditional senior debt instruments will be used for small *dekassegui*-owned businesses that represent good credit risks, but that are not able to receive loans in the Brazilian banking sector. Such businesses may have weak collateral or no prior credit history, but are otherwise creditworthy. Senior debt will be used in combination with straight equity to satisfy working capital needs and enable the Fund to provide an investee with the necessary capital without taking a major equity stake. The senior debt instruments issued by the Fund will thus address current gaps in small business financing in Brazil. The terms of most senior loans would be relatively short and the portfolio would mainly consist of existing equity investees. As the size of the loans is expected to be smaller than that of quasi-equity and equity investments, the share of senior debt in the overall portfolio of the Fund would be small.

7. The Role of Banco do Brasil

7.1 The Project is proposed and promoted by Banco do Brasil. Banco do Brasil is the largest financial institution in Latin America. The bank has been in existence over 190 years, and as of the end of 1998, had 72,000 employees, held R$ 130 billion in assets and R$60 billion in deposits, had 10 million customers and 5,000 points of service, directly operated in 2,700 Brazilian municipalities, reached the overseas market through 34 operating units and was the leader of the mutual fund and portfolio market in Brazil with over R$25 billion assets under management. Indeed, with net assets of R$25.3 billion at the end of 1998, Banco do Brasil remains the largest asset manager of Brazilian-sourced investment funds. Of this total, 77% was in fixed income and 23% in equity funds

7.2 Banco do Brasil is committed to contributing to the productive sectors of Brazil's economy. This is demonstrated through Banco do Brasil's generation of business throughout the agricultural chain, in strengthening of small and medium-sized businesses and the expansion of foreign trade activities. The available data as of the end of 1998 demonstrates the following: Banco do Brasil is responsible for financing 80% of the farm harvest, invests R$ 1.5 billion in over 87,000 individual working capital operations for micro and small companies, and holds 27% of the Brazilian foreign exchange market.

7.3 *Brasil-Emprendedor and Sala Dekassegui*

Banco do Brasil is also rapidly acquiring experience in small business transactions. It is one of the banks selected by the Federal Government to act as an agent for implementing a new program for entrepreneurs launched in mid-1999 by the Cardoso administration-"Brasil-Emprendedor".

The program, which amounts to R8 billion reais (US$4.5 billion), is designed to channel financial resources to microenterpirses. According to the government's plan, one million entrepreneurs will receive financing through this program. The maximum loan amount is US$27,000, with a 60 month repayment term (including a 6 month grace period) and normal commercial rates. The Brasil-Emprendedor program requires collateral of 200% of the loan amount. As of the end of 1999, Banco do Brasil, which is responsible for analyzing the loan proposals for new businesses, disbursed US$240 million to 34,000 operations (an average of US$4,000 per loan). This government program has been executed in coordination with SEBRAE, which arranges technical assistance/training programs for potential beneficiaries.

7.4 In Japan, Banco do Brasil holds more than 100,000 accounts of *dekassegui* and quasi-permanent residents through 8 branches throughout the country. The amount of the account corresponds to 50% of the overall amount of the accounts held by all the *dekassegui* community. In August, 2000, the Bank inaugurated a *Sala Dekassegui* program in its Libertade branch **(**Libertade is a primarily Japanese community in Sao Paulo) to provide business and financial advice to returning *dekassegui*, particularly with regard to starting a new business. This program will be used to identify entrepreneurs who may obtain financial assistance through *Brasil Emprendedor*. Alternatively, it can be used as a source of generating deals which are risky due to a lack of collateral, but promising, and thus appropriate for the proposed Fund.

8. <u>Financing and Investment Return</u>

8.1 The following is a provisional budget for the proposal (US$):

	Amount
IDB/MIF	5,000,000
SEBRAE	4,500,000
Fund Management Company (Banco do Brasil and Banco Fator)	500,000
Private Investors (from Remittance)	2,000,000
Total	12,000,000

8.2 The Fund is expected to generate 10-15% as an annualized rate of return for investors upon its liquidation. Since equity investment in startups needs a longer period of holding, dividend payments during the operating life will be limited (other than the fixed payment to the *dekassegui*). MIF funding is contingent on commitments, and disbursement will be made only on a matching basis with other investors and contributors.

9. <u>Timetable for Approval</u>

Abstract MIF	November 2000
Donors Committee	February 2001

10. <u>Issues</u>

10.1 *Marketing Risk*: Marketing of the cumulative partially participating preferred shares to the *dekassegui* may be more difficult than anticipated. Because of Brazil's economic history, many Brazilians are wary of long-term instruments and may balk at a 10 year preferred share, no matter what the return. It would, of course, be possible to structure a one or two year security that pays a dividend (but that does not offer the 5% of "excess" gains offered by the currently proposed

preferred); however, although such an instrument would attract inflows of capital, it would not meet the developmental goals of channeling current savings into productive uses. Rather, it would simply provide the *dekassegui* a savings instrument that might generate a higher return (and the holders of the security, upon cashing in, may simply use that return for consumables). Furthermore, the term mismatch of such an instrument would be somewhat burdensome, particularly in the early years of the Fund's operation. An incentive that could be built into long-term preferred security is the preferential consideration for providing zero-interest seed capital loans to assist the investing *dekassegui* in developing a business plan. This, of course, would not guarantee that the Fund would invest in the preferred investor's business, but it would increase the chances that said investors could obtain risk capital funds for his/her new enterprise. Another option is granting the preferred investors a put option, allowing them to sell the preferred back to the Fund Manager after 5 years. The latter option would provide some additional liquidity to the instrument in the later years, and would, in a sense, force the Fund Manager to increase its management discipline, given that they may need to buy back the stock and rely on the dividends and 5% share of the Fund's gain to counter the expenses of the purchase.

10.2 *Currency Risk*: The Fund's investments will be primarily equity or equity-like denominated in Brazil's local currency, *reales*. The investment value may be affected by currency fluctuations as the Fund does not expect to hedge the currency exposure. This risk should be mitigated by rigorous selection of portfolio companies with inflation adjusted pricing or dollar cash flows. As individual investment terms are expected to be four to five years, short-term currency fluctuations should not affect the value of the returns.

10.3 *Business Risk:* The Fund will primarily target start-up companies, which are subject to higher operating, management and financial risks than large, public companies. Through the Fund manager's "hands-on" assistance, entrepreneurial skills should be enhanced and seed and start-up capital should be effectively utilized to improve business feasibility.

10.4 *Exit Risk:* The Fund's investments in companies whose shares are not listed on a stock exchange are subject to less liquidity and greater risks than those inherent in publicly, actively traded securities. Even if the Fund is able to exit by selling securities in the local stock market, the securities market is substantially smaller, less liquid and more volatile than the major, developed securities markets elsewhere in the world. The limited liquidity of the securities market in general and of the types of companies in which the Fund proposes to invest, as well as the size and nature of the local securities market, may adversely affect the Fund's ability to acquire or dispose of securities at the price and time it wishes to do so. The Managers should have track records in exiting investments through third-party sales and management buy-backs. Their business contacts will be instrumental in supporting the Fund's exit from their investments. The ability to structure divestment alternatives before the investment can enhance exit values.

10.5 *Deal Flow Risk*: The number of projects in the Fund's target deal size range may be fewer than anticipated, which could pressure the Fund to make lower-quality investments and produce lower-than-expected returns. The business of identifying and structuring investments may become highly competitive, and involves a high degree of uncertainty. However, the proposed Manager has already identified a growing pipeline of potential investments in Brazil, and *Sala Dekassegui* as well as business incubators provide a ready pipeline of businesses. In addition, the seed capital component of the project will assist *dekassegui* entrepreneurs to prepare viable business plans for their fledgling businesses. One of the advantages of Banco do Brasil and Banco Fator's extensive network of referral sources is that they can introduce companies to support services provided by local and international enterprises while using those enterprises as informal marketing agents.

10.6 *Investors' Commitment*: The appraisal will include meeting with prospective investors to firm up their level of interest in the investment. MIF funding would be contingent on commitments being obtained for the total amount.

10.7 *Conflicts of Interest*: Those funds being managed by a consortium of BBDTVM and FAR are so-called "captive" ones in which the parent conglomerate's arms are inter-linked so as to generate mutual benefits. Thus, there is a risk that BBDTVM, as Banco do Brasil's subsidiary, may engage in those financial transactions for the benefit of Banco do Brasil and its group. To the same effect, FAR, being a subsidiary of Banco Fator, a universal investment banking service, may also engage activities for the purpose of benefiting BancoFator. The team should develop an appropriate mechanism to avoid this potential conflict of interest.

Table 1. Rough Sketch of Remittance Fund