EQUITY INVESTMENT IN THE VENTURE CAPITAL FUND BOLIVIA CAPITAL ACTIVO (BCA)

(TC-98-04-34-6)

EXECUTIVE SUMMARY

INVESTEE: Fondo Bolivia Capital Activo (BCA Fund), a Bolivian for-profit investment company (in development)

MANAGER: Small Enterprise Assistance Funds (SEAF), subsidiary in Bolivia

CAPITAL STRUCTURE:

Investors	(US$)
MIF:	4,900,000
CAF:	2,000,000
Others:	3,100,000

SOCIAL AND ENVIRONMENTAL IMPACT: The fund's investment policy will ensure that its investee companies do not invest in environmentally harmful practices, in keeping with the environmental policies of the Bolivian authorities, SEAF, fund shareholders, and IDB environmental guidelines. The project's technical files include a summary of the environmental and labor policies that SEAF has been following as the manager of a number of investment funds in Eastern Europe established with funds from the European Bank for Reconstruction and Development (EBRD) and as manager of the Small Business Assistance Fund (FAPE) established with MIF resources in Peru.

PROJECT OBJECTIVES: The **general objective** of the project is to create a venture capital fund for small Bolivian companies that will provide an effective and commercially viable vehicle to assist in the business development of small companies in La Paz, Santa Cruz, and other Bolivian cities. The fund will have an operating life of ten years.

The fund's **specific objectives** are to: (i) offer venture-capital finance instruments to companies that show growth potential, (ii) create jobs, as part of the growth process of the companies in which the fund invests, (iii) provide transfer of technology and technical, management and production assistance to companies in which the fund invests, (iv) help generate foreign exchange through the development and growth of exports from the fund's companies, (v) spread the use of venture capital to finance

small businesses and train professionals in Bolivia in venture-capital management, and (vi) support the development of capital markets in Bolivia through the expansion of small businesses that could in future be candidates for investment from other venture capital funds or could look to the stock market to augment their capital.

DESCRIPTION OF FUND:

The target size of the fund will be US$10,000,000, with the MIF holding 49% of the shares, the Andean Development Corporation (CAF) 20%, and other investors the remaining 31%. Within this group of other investors, preference will be given to private Bolivian investors, although investment will also be open to private and public institutions in Bolivia and abroad. Minimum capitalization as a condition for the first disbursement will be US$5,000,000.

The target size of investee companies will be between 10 and 99 employees, with annual billings prior to the investment of between US$100,000 and US$1,000,000. The fund will make investments in 40 small businesses and will hold a minority stake in their ordinary capital, with investments averaging between US$50,000 and US$300,000. The investments will be accompanied by managerial support and technical assistance to be provided by the fund's investment officers and other technical assistance programs now operating in Bolivia.

The fund will be managed by Small Enterprise Assistance Funds (SEAF), for which purpose it will create a subsidiary in Bolivia (SEAF-Bolivia). SEAF is a professional fund manager which is currently administering seven funds of this nature in Eastern Europe and one in Peru. The Peruvian fund (FAPE) was created in early 1997 by the MIF, CAF, and FMO of the Netherlands.

Regarding returns on the funds that SEAF is managing, it is still too early to measure their financial performance (see Annex III for more details on fund results). However, CARESBAC-Polska, SEAF's oldest fund (created in March 1992) was one of the first investment funds in eastern and central Europe to pay dividends to investors (that fund has yielded a profit since its fourth year). In 1997, it posted pre-tax earnings on the order of US$1,000,000. Of the 41 investments made, three of the first were total losses, four have already been sold, and one is in the process of being sold. As a result of these divestments, the weighted internal rate of return on

these investments has been approximately 22%. This could increase to 24% looking toward the selling price being negotiated for the sale of the fifth investment in the portfolio. Assuming that this trend continues and the investments yield an average internal rate of return of 24%, and estimating that 20% of the portfolio will be total losses, the return before operating and administrative expenses will be 19.2%. Thus it is anticipated that a before-tax return of about 12% will be achieved.

SEAF's investment strategy is to add value (through technical assistance) to the investments in its portfolio over the years it remains a stakeholder in a company (4-6 years) in order to boost the return on investment and facilitate the exit.

The development impact will take the form of job creation and foreign-exchange generation as the fund's investee companies grow, along with the creation of a commercial financing model for business development that could be expanded and used by other investors. The fund will help spread the experience of equity finance use as a funding avenue for small businesses, and will help create and develop a venture capital industry in Bolivia.

SEAF's experience as far as the development impact of its funds' investments is concerned has been very positive. The performance of the Poland fund – the oldest and largest – is illustrative: (i) a 75% increase in number of jobs created, compared to a 3% decline in the economy as a whole (1991-1995); (ii) a 118% rise in real income, compared to 27% for the economy as a whole (1992-1996); (iii) an 89% increase in social security pay-ins, compared to a 5% drop in the economy as a whole (1991-1996); and (iv) a 49% increase in income tax payments, versus a 32% decline in the economy as a whole (1991-1995). The other SEAF-managed funds show similar track records (further information available in the MIF project files, Annex III).

PROJECT ELIGIBILITY: The experience of the IIC and MIF in supporting small and mid-sized businesses in the region points up the difficulties faced by these types of firms in securing long-term finance from the commercial banking system and other local sources of financing. One major factor contributing to this situation is the limited capital on these companies' balance sheets. Commercial banks have to comply with specific requirements and prudential standards that

demand specified levels of corporate capitalization, to afford adequate guarantees. The primary avenue for financing the growth of these companies has been reinvestment of their profits – this being a source that seriously curtails the companies' growth potential. Another important factor standing in the way of these small firms' access to commercial bank services is weak management practices and lack of a solid corporate apparatus.

The BCA Fund will help strengthen the capital base and make for more institutionalized management of small Bolivian businesses. A fund of this type can be seen as an effective vehicle not only for business development but also to support the deepening of the financial system and development of the capital market. The work of the fund, as a source of both capital and technical assistance, will better position the small businesses in its portfolio to take advantage of present-day opportunities in the financial sector.

The BCA Fund will be Bolivia's first venture capital fund. Although the equity investment fund approach to financing is being used more frequently now in the region, Bolivia has not yet had experience with this type of finance.

RISKS AND MITIGATING FACTORS:

Divestment: Previous experience with equity investments shows that exit from or divestment of small businesses is more difficult in developing countries that have less evolved capital markets. To mitigate this risk, the manager will use a variety of instruments, including: (i) offering purchase (call) options or sale (put) options to the investee companies, and providing buyback incentives at a prearranged rate of return; (ii) should the entrepreneur decide not to exercise the call option, the fund will have the right to offer its stake in the company to outsiders; (iii) sale to the company's employees; (iv) sale to a strategic investor; and (v) in some cases, sale to another investment fund or on the stock exchange. In all cases, the manager will determine the exit mechanism prior to approval of the investment.

Resistance to opening up the capital of small businesses: A further important risk factor for the proposed operation is entrepreneurs' willingness to open up the capital of their businesses to the fund. The novelty of this type of financing for Bolivia, particularly for small businesses, will put to the test the manager's ability to generate enough

confidence to close the deals. Mitigating this concern is the experience of the manager, which has made more than 110 investments in small companies in different parts of the world. In particular, the fund it has been managing for about a year in Peru (FAPE) has approved ten investments and closed eight. SEAF's investment methodology, grounded in a close technical-support relationship with its companies, attracts entrepreneurs who are looking for strategic partners not only to finance expansion but also to provide definitive added value to the workings of the company by way of technical assistance. The fund will have investment officers qualified to advise entrepreneurs and contribute this added value.

Market. The potential market assessed by the manager is large enough to identify 30 to 40 sound business opportunities. However, the country's economic climate can change, and this might affect the expansion plans of small businesses, making it difficult to come up with good opportunities for the fund. To counter this risk, the fund will be highly diversified among various sectors and different geographic markets within Bolivia.

Management. SEAF's policy is that its fund managers must be individuals with proven experience in investing in small businesses using the SEAF methodology. In the case of Bolivia, the proposed manager is a U.S. national who is bilingual in Spanish and English. To ease any risk associated with a limited knowledge of the local environment, the first fund closing envisions significant participation from the local private sector as investors. Both the individual investors and Bolivian institutions that are being considered as potential investors in the fund will bring with them this in-depth knowledge of the market and local contacts that will facilitate the manager's work.

In addition, all the other SEAF-Bolivia staff will be recruited locally and will be well-versed professionals with good contacts who are capable of interacting effectively with companies in the Bolivian market.

Concentration. In order to spread the risk, the fund will not invest more than 30% of its capital in any one productive sector in Bolivia and may not invest more than 10% of its capital in any one company.

Exchange risk. The Fund will make equity investments denominated in local currency. Hence, any

significant devaluation of that currency could impair the value of the fund's net assets. Mitigating factor: At present, investment fund managers have no viable mechanisms to hedge against major currency devaluations. The risk entailed in equity investments is considerably greater than the risk in cross-border lending, and it is thus to be expected that equity investment yields will also be higher. Consequently, the most important factor mitigating against the risk of value impairment from a devaluation is a proportionately higher yield from the investment in local currency. To the extent that the fund manager identifies investment opportunities in companies whose composite yield exceeds the rate of currency devaluation, the devaluation exposure of the fund and of IDB-MIF will be diminished. This exchange impact will likewise be mitigated by: (i) the medium-term profile of the fund's investments, which will leave their yield less sensitive to short-term exchange fluctuations, and (ii) the export focus of the portfolio companies, which in the event of devaluation will see their export markets expand.

SPECIAL CONDITIONS:

1. Prior to the first disbursement, SEAF must demonstrate that: (a) it has established in Bolivia a subsidiary company to manage the fund and has appointed a general manager, and (b) it has obtained firm investment commitments from investors, including IDB-MIF, in an amount of at least US$5,000,000, of which it is estimated that at least 40% should represent the group of investors made up of the CAF, Bolivian investors, etc.

2. The second and subsequent IDB-MIF disbursements will be contingent upon a demonstration of firm commitments from the investors, including IDB-MIF, to increase the fund's capitalization to at least US$10,000,000.

3. The fund's capitalization period will be 18 months from the first capital subscription and signature of the shareholders' agreement.