

NORTHEAST BRAZIL SMALL BUSINESS FUND

(TC-00-09-01-2/TC-00-09-01-4)

EXECUTIVE SUMMARY

Executing agency: Banco do Nordeste (BN) for technical assistance and Banco Pactual (BP) as venture capital fund administrator.

Project number: Venture Capital Fund TC0009012
Technical Support TC0009014

Beneficiaries: Small enterprises, institutions providing business support services and entrepreneur networks in the Northeast of Brazil.

Financing: The project will provide for MIF investment of US\$6,000,000 to establish the investment fund and a nonreimbursable contribution of US\$750,000.

Equity investment (Facility III-B):

IDB/MIF	US\$ 6,000,000
Banco do Nordeste:	US\$ 6,000,000
Banco Pactual:	US\$ 1,000,000
<u>Private Sector:</u>	<u>US\$ 2,000,000</u>
Total:	US\$15,000,000

Nonreimbursable funds (Facility III-A):

IDB/MIF	US\$ 750,000
Banco do Nordeste:	US\$ 375,000
<u>Local agencies (*):</u>	<u>US\$ 375,000</u>
Total:	US\$1,500,000

(*) Coexecuting agencies in the three states participating in the project: Bahia, Ceará and Pernambuco.

Time periods: The period for execution of the technical assistance components is expected to be three years, while the disbursement period is three years and six months. The venture capital fund would be disbursed in three years, with an expected life of eight years. The disbursement period may be extended for another year, but the life of the fund may not exceed 10 years.

Environmental Classification:	The Committee on Environment and Social Impact reviewed and approved the project proposal at its 20 April 2001 meeting. Comments received have been taken into account.
Objectives:	<p>The project's general objective is to promote the growth of innovative small enterprises (SEs) by providing access to capital financing, strengthening the business skills of entrepreneurs and modernizing business management practices. Through this operation, the MIF and the BN are seeking to obtain a significant demonstration effect for the development of capital financing instruments for small enterprise.</p> <p>The specific objectives are: (i) the establishment of a venture capital fund aimed at innovative and technological small enterprises (SEs) based in the Northeast of Brazil; (ii) the supply of business training courses geared to enterprise growth; and (iii) the introduction of a system to bring the business community and potential investors together for new business initiatives.</p>
Project description:	<p>Venture capital fund. The fund will be set up as an emerging fund, regulated by CVM Rule 209. The fund will be managed independently through professional services provided by Pactual Asset Management (PAM), a fully-owned subsidiary of Banco Pactual.</p> <p>The fund will invest in innovative small enterprises, defined as enterprises with less than US\$5 million in sales and fewer than 100 employees. The fund may invest in startup companies that have a potential for growth and profitability, but will focus on enterprises in the early stages, with sales of approximately US\$1 million to US\$1.5 million. On first approach, the fund's strategy will be to direct the search for investment opportunities towards specialized industrial clusters that show greater technological momentum, in particular software, fine chemicals, capital goods (microelectronics and electrical engineering), biotechnology, tourism and food technology.</p> <p>Strengthening of entrepreneurial capacity. This technical assistance component provides for the strengthening of the management capacity of entrepreneurs, particularly in an enterprise's expansion stage, by sharing and adapting successful experiences in business capacity development. This component includes three elements:</p> <p>(i) Venture capital awareness and education. This activity attempts to disseminate venture capital methods and the conditions needed to properly implement them. The events under consideration are: (a) one-day seminars, one in each state in the Northeast, to spread the concept of venture capital and create investment opportunities for</p>

the venture capital fund; (b) two- to three-day seminars, which are more in-depth and technical; and (c) publication of a series of articles on venture capital (best practices, success stories and methods) in the economic press and local trade journals.

(ii) **Expansion of programs supporting business plan design.** These programs are associated with the incubators and normally executed with university support. The project contemplates funding the transfer and adaptation of methods applied in positive international experiences from similar programs.

(iii) **Implementation of specialized management courses.** The project seeks to introduce high-quality, specialized and very specific courses of immediate practical application. This is the principal activity related to the transfer of successful experiences. The project will finance educational materials and curriculum planning according to international best practices, as well as trainer training. During the analysis, three subjects were identified as priorities financial management, corporate governance and negotiation, with respect to both financial institutions and clients/providers.

Business support and investment networks. This component seeks to set up business investment and support networks comprised of experienced entrepreneurs, like “Business Angels,” willing to devote a small portion of their time and/or capital to embryonic but innovative and dynamic enterprises.

Risks:

Commitment by Banco Pactual/PAM to the fund, in view of its many obligations. *Mitigating factor:* This possibility is remote because: (i) PAM has shown a strategic interest in administering the fund not only to expand this sector of activity but to enhance its presence in the Northeast; (ii) it is expected that both PAM’s point person for the fund (Leonardo Corrêa) and the manager to be hired will receive a portion of the 20% of PAM’s profits as part of their compensation; (iii) the Pactual/PAM commitment will also be guaranteed by “key-man” and “time commitment” clauses which, if not complied with, could lead to the administrator’s dismissal; (iv) Pactual is investing US\$1 million in the fund; and (v) as a private fund manager, Banco Pactual’s image and reputation are very important to its success.

PAM’s limited experience as a venture capital manager. *Mitigating factor:* PAM, which for a number of years has been involved in venture capital transactions within its area of corporate financing and manages the Pactual Internet investment fund, will also participate by contributing its know-how. It also has relevant experience in effectively managing a venture capital fund in areas such as mergers and acquisitions or corporate banking. Lastly, also in this case, both the institution’s reputation and Pactual’s strategic interest in

positioning itself as a venture capital and/or private equity fund manager will ensure greater institutional commitment to succeed.

Director of the management company. Although the requirements for hiring the candidate include in-depth hands-on knowledge of the problems and needs of the small enterprise, they do not necessarily imply prior experience in managing investment funds. ***Mitigating factor:*** The Director will receive support from a full-time staff based in Rio, from the Investment Committee and the partners of Pactual, who are professionals with considerable relevant experience. Moreover, the MIF will consider the choices proposed and will give its nonobjection to the candidates. Also, one of the MIF's objectives with its venture capital operations is to help strengthen the fund managers' network.

Sufficient market. The fund's regional approach could limit investment opportunities, since there is a possibility that the regional market may be too small for the selection of enterprises for the Fund. Also, PAM has little experience in the Northeast. Entrepreneurs in the region are not familiar with the venture capital instrument, and at times their idea of management may not be appropriate. ***Mitigating Factor:*** The fund director will have worked previously in the region and possess full knowledge of the market and its players. The management company, with the support of the BN, also has an extensive network of contacts that may be able to ease the work of project prospecting and identification. The technical assistance activities contemplated by the project will create synergy, improve the investment environment, enhance business skills and provide greater fund exposure.

Exit strategy. The fact that investments will be made in a region that is not central to the country's economy is another consideration. ***Mitigating factor:*** To alleviate this risk, the management company will use a number of different instruments, among them: (i) put options for entrepreneurs and portfolio enterprises, (ii) sale to strategic investors, and (iii) exit to capital markets or sale to private equity funds. Pactual's network of contacts in the markets can facilitate these transactions.

Exchange risk. The fund will make equity and quasi-equity investments in local currency. ***Mitigating factor:*** The major factor in mitigating the risk of loss of value due to devaluation is a return that is proportionally greater than the investment in local currency. To the extent that the fund manager identifies investment opportunities in companies whose combined performance exceeds the currency devaluation rate, the exposure of the IDB-MIF and the fund to devaluation will be lessened, which is a specific fund resource allocation strategy. Furthermore, this exchange impact will be

alleviated by: (i) the application of a capital value adjustment index (the IGPM or General Market Price Index); (ii) the medium-term nature of the fund's investments, which will make performance less sensitive to short-term exchange fluctuations, and (iii) the export potential of portfolio enterprises, which, in the event of a devaluation, will have expanded their export markets and have foreign exchange income.

Attracting additional resources. As in all capital fund operations, there is the risk that the management company will not be able to raise the minimum private capital necessary to start the fund. **Mitigating factor:** Although macroeconomic conditions can always adversely affect the capitalization of the fund, the project team is optimistic about the management company's capacity to obtain sufficient private capital to close the fund for the following reasons: (i) the Government of the State of Pernambuco has given clear indications of the existence of local private investors interested in investing in the fund (approximately US\$1,000,000); (ii) Pactual's solid reputation as an asset manager, its proven ability to raise other venture capital funds in the amount of R\$75 million (largely from Brazilian institutional investors) in 2000, and its network of national and international institutional investors, were fundamental factors in choosing Pactual as the fund manager; and (iii) the management company undertakes to invest US\$1,000,000 of its own funds, and the project team feels that Pactual's financial situation is sufficiently sound to cover the minimum amount with its own resources in the event that it does not raise the rest of the US\$2,000,000 in private funds.

Special conditions:

The **first disbursement of the MIF contribution** will be subject to: (i) entry into effect of the operating regulations; (ii) selection of the project director; (iii) evidence of the establishment of the executing unit; (iv) evidence of the signing of the agreement between the BN and the local coexecuting agencies; (v) the work plan and disbursement schedule for the first six months of operations prepared to the IDB's satisfaction.

The **first disbursement of the investment component** is subject to (i) evidence of the approval of the fund and authorization to operate by the CVM; (ii) the hiring of the fund director; and (iii) share subscriptions by private investors in the amount of US\$3 million.

In addition, the following conditions must be fulfilled prior to any disbursement: (i) the management company maintains the staff who will manage the fund as defined in the regulations; and (ii) all the MIF disbursements are *pari passu* with those of Banco do Nordeste.