

TC Profile

I. Basic Project Data

- ❑ Country/Region: Mexico
- ❑ Program Name/Number: Enabling venture financing for Mexican early-stage technology firms. ME-M1005.
- ❑ Team Leader/Members: Miguel Aldaz (MIF/INV), team leader; Antonio Ca'Zorzi (SDS/ITD); Lisa Restrepo (MIF/INV); and Valentina Sequi (MIF/INV)
- ❑ Date of Request: September 2003
- ❑ Beneficiary: Mexican technology Small and Medium Enterprises
- ❑ Executing Agency: Latin Idea Mexico Venture Capital Fund II, L.P.
- ❑ Financing Plan: First closing

MIF (IIIB)	US\$ 5,000,000
Conacyt	US\$ 5,000,000
NAFIN	US\$ 5,000,000
<u>Private Investors</u>	<u>US\$ 6,500,000</u>
Total	US\$ 21,500,000

MIF (IIIA)	US\$ 65,000
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- ❑ Technical and Basic Responsibility: MIF Investment Unit
- ❑ Tentative Dates: POC February 2004
Donors April 2004

II. Background and Problem Statement

- 2.1 Within the already difficult environment for Small and Medium Enterprise (SME) financing in Latin America and the Caribbean (LAC), one group that is especially cut off from growth capital are young technology firms. There are a number of reasons for which technology companies are unattractive candidates for the “traditional” sources of financing available in LAC. Most notably, the fact that loans are inaccessible to companies with few assets as well as the difficult cash position of most of these SMEs, makes debt financing a poor option for achieving maximum growth.
- 2.2 A study conducted by Nacional Financiera S.N.C. (NAFIN) confirms that the growth of Mexican SMEs in technology sectors is constrained by the lack of credit that results from high interest rates, short-term maturities and the need for onerous guarantees, as well as the lack of alternative sources of capital. NAFIN statistics indicate that while SMEs represent more than 50% of Mexico’s business activity, they face significant challenges in accessing capital from traditional financing sources. In comparison with similar US companies, Mexican SMEs have little or none access to venture capital (VC) such as the Fund expects to provide. Mexican VC in more traditional sectors including manufacturing, retail, etc; is still at an early stage and lags many years behind more developed markets

- such as the United States or other Latin American countries such as Brazil or Chile, while in some sectors such as technology is still practically nonexistent.
- 2.3 The globalization of technology affords tremendous new opportunities for wealth creation in emerging economies through the application of technology to achieve efficiencies and enhance productivity in traditional industries.
 - 2.4 The Mexican market offers an untapped potential of entrepreneurial opportunities that typically suffer from a lack of dedicated venture funding sources in the country. Mexican universities (particularly the tech-oriented ones) are producing increasing numbers of independent-minded future business leaders who look at the US model of entrepreneurship for inspiration. Along with the substantial development of the skilled labor force in Mexico and a greater tendency toward sophisticated management and corporate policies within Mexican companies, the newest Mexican companies have the potential to rapidly build businesses and create value for their respective owners.
 - 2.5 According to The Global Entrepreneurship Monitor 2001 study, 18% of Mexicans are involved in entrepreneurial activities, one of the highest percentages in the developing world. Nonetheless, entrepreneurial initiatives are often stalled by lack of financing as evidenced by the fact that according to the Venture Finance Institute of Mexico, fewer than 11% of start-ups in Mexico succeed in raising third party capital. Even in those cases that do raise capital, the limited resources mostly come from friends and family.
 - 2.6 In addition, Mexico's position as the second largest commercial partner of the United States, and its improving economic stability, facilitate the growth prospects of local technology firms and creates the right conditions for strong exits for technology investments.

III. Program Objective and Description¹

- 3.1 The project envisages the creation of: (i) the *first technology* VC fund for Mexico; (ii) the *first* MIF-sponsored Mexican VC fund targeted at local SMEs that has strong *private sector commitment* since its inception; and (iii) the *first* specialized technology VC *management team* in Mexico.
- 3.2 The objectives of the project are:
 - To promote technology entrepreneurship in Mexico by providing growth financing for up to 12 early and middle-stage technology-based SMEs that, if successful, will become role-models for others to follow;
 - To promote the adoption and use of technology innovations among SMEs, increasing their competitiveness and generating high-quality employment;
 - To lead the nascent VC technology sector in Mexico;

¹ The MIF is canceling its US\$ 5mm commitment to ZN Mexico II VC fund due to managerial poor performance. As a result, the MIF country exposure towards Mexico won't increase once Latin Idea deal is approved.

- To guide government institutions with an interest in promoting development of the technology sector (such as CONACYT²) on how to invest and manage a Fund; and
 - To promote VC fund raising among non-traditional investors in Mexican VC funds. In what could be another “first”, the fund manager is in advanced negotiations to raise additional funds from Mexican asset managers³.
- 3.3 This project is in line with the MIF OVE Evaluation⁴ recommendation to prioritize technology-focused funds, especially in an environment where funds, clusters of technology companies, and functioning institutions come together. Accordingly, this Fund is one of the first and key components in trying to replicate the highly successful experience of the Brazilian Innovar Project.
- 3.4 The Fund will make VC investments in Mexican companies who use technology as a driving force in achieving significant growth in revenues and profits and, consequently, achieve value creation. The Fund will concentrate its investment activities primarily in the services, media, information technology and communications sectors, which continue to grow in Mexico as a result of local and foreign investment. The Fund has targeted these sectors not only for their intrinsic potential and based on the Fund administrator’s expertise, but also because of their suitability to the application of basic and advanced technologies as a driver of value creation. By contributing its management expertise, acquired as successful serial entrepreneurs and fund managers, as well as introducing the concept of applied technology, the Fund will be able to extract additional efficiencies that enhance value creation. This will involve, for the most part, basic technology transfer from proven US and European sources, or in other cases, the use of cutting-edge technologies that allow companies to leap-frog older generations at lesser cost and produce higher efficiencies, competitive advantages and barriers to entry.
- 3.5 The Fund plans to make investments that meet the following objectives: (i) control or influential minority positions; (ii) be a growth-oriented investor, targeting undervalued companies that lack the capital to achieve significant growth in revenues and profits and relevant critical mass; (iii) create value by taking a very active “hands-on” role in the strategic and financial direction of its portfolio companies; (iv) investments of at least USD \$500,000 with an average investment size of USD \$ 2 million; (v) invest up to 15% of its capital in each portfolio company. The Fund may seek to co-invest with local or strategic investors who bring value or expertise to a portfolio company; (vi) The Fund will seek to minimize risk by diversifying its portfolio according to industry; size and

² Conacyt has received the mandate of becoming a “fund of funds” along the lines of the MIF Investment Unit model. MIF is actively helping Conacyt in achieving this goal.

³ This is extremely important as Mexican institutional investors like Pension Funds cannot invest in VC funds, making foreign capital nearly the only alternate funding source available in Mexico. Asset Managers only deal with the wealthiest Mexican families (qualified investors).

⁴ Evaluation of MIF Projects: development of venture capital. Office of Evaluation and Oversight. MIF/GN-78-11.

stage of development; and seniority of the various securities purchased; and (vii) investment opportunities that have a potential for exit within a 5-year time frame.

IV. Cost and Financing

- 4.1 The Fund is planning a first closing of at least \$20 million and expects to reach its \$30 million by further targeting Mexican and foreign individual investors after its first closing. This size is necessary to attain the critical mass necessary for the Fund to make investments according to the investment strategy devised and the market reality.
- 4.2 To date, the Fund has secured indications of interest totaling USD \$16.5 million including \$5 million each from two Mexican institutions (NAFIN and CONACYT) and the balance coming from Mexican private individuals, of which \$1.0 million is being committed by the Fund administrators themselves.
- 4.3 Compensation. The Fund has been initially designed to include an annual fee to the administrator of 2.5% of the aggregate capital commitments during the investment period and 2.5% of the portfolio assets thereafter.
- 4.4 Remuneration. Cash received by the Fund from the sale, transfer or other disposition of any Security acquired by the Fund, and cash received by the Fund from dividends will be distributed to the investors as follows: (1) to each investor pro rata in proportion to the capital contributions made by the investor to the Fund until each investor has received distributions equal to the amount of all capital contributions he has made; (2) a “Preferred Return” of 8% per annum to be credited against future profits; and (3) 80% of any remaining amount will be distributed to the investors pro rata in proportion to their capital contributions to the Fund, and 20% to the Fund administrator.
- 4.5 The MIF, however, is in discussions with the Fund administrator to evaluate alternative fee structures that incorporate a greater proportion of incentive based fees and fewer fixed fees. The proposal has been tentatively accepted by the fund manager as is based on the lessons learned from SEIF portfolio. A new compensation and remuneration structure will be negotiated during the due diligence.
- 4.6 The Fund will have an Investment Period of five years and will terminate 8 years from the final closing date. Upon termination of the Fund, its assets and affairs shall be liquidated and distributed to the investors.

V. Executing Agency and Execution Structure

- 5.1 The administrator of the Fund is Latin Idea Ventures, L.L.C., a Delaware limited liability company owned by Messrs. Humberto Zesati and Alexander R. Rossi.
- 5.2 The Project Team decided not to bid-out the Fund’s administration because of: (i) the very significant private sector commitment that Latin Idea Ventures brings as

- well as the potential new private funding sources it's tapping through the asset managers; (ii) the combined entrepreneurial and managerial experience of both fund managers which gives them an ideal profile; (iii) the skills and background of both Fund managers which complement each other; (iv) the pre-negotiation terms proposed by the Managers which are reasonable and justified; and (v) the absence of other relevant players in the Mexican technology sector.
- 5.3 Messrs. Humberto Zesati and Alexander R. Rossi have extensive experience in the Mexican corporate market both as investors and advisers in the services, media, and information technology and communications sectors. They have collectively made VC investments in over fifteen Mexican companies and have transactional experience in over twenty Mexican companies and one hundred companies throughout Latin America and the United States. Mr. Zesati and Mr. Rossi have a five-year history of working together as professionals and partners.
- 5.4 Humberto Zesati has been at the forefront of VC investment in Mexico over the last ten years as a "serial entrepreneur". He has served as CEO of a number of start-ups overseeing their growth and disposition, generating substantial positive returns. In his most successful venture, Mr. Zesati was a seed investor in Cinemex and exited to a foreign strategic buyer, earning a 3.5x return on his investment.
- 5.5 Alexander R. Rossi has been involved in Latin America investment banking since 1990, focused primarily on the Mexican market, and has worked with many early stage companies in the media, communications and technology sectors. For the last several years, Mr. Rossi⁵ has been a Managing Director at Communications Equity Associates, LLC (CEA⁶), a leading investment bank and private equity firm dedicated to the media and communications industries. Mr. Rossi has been instrumental in structuring venture and private equity deals for several companies and has generated multiple exit transactions for entrepreneurs and private equity investors during his career.
- 5.6 The fund managers have extensive experience in structuring venture investments having formed in 2000 a small all-private VC fund with \$2.4 million in capital. This fund made six investments at the height of the dot-com boom of which three have been liquidated, two are meeting expectations and a third is proving extremely successful at a current valuation of \$2.7 million. The support from institutional investors like MIF will enable the Team to raise their first professional-scale fund, giving rise to the first technology VC management team in Mexico.
- 5.7 In addition to Messrs. Zesati and Rossi, the Fund management team will also include a full-time Associate as well as a controller and an administrative assistant who will jointly assist with financial and administrative matters related to Fund investments and the operation of the Fund.

⁵ Mr. Rossi is currently living with his family in Mexico City.

⁶ The Inter-american Investment Corporation (IIC) is investor in this deal. The references provided by the IIC on Mr. Rossi are excellent.

- 5.8 The Fund administrator has organized an Operating Management Board consisting of prominent businessmen and senior executives with extensive operating and relevant industry experience in the sectors targeted by the Fund in Mexico to assist in overseeing the Fund's portfolio companies. The administrator has also appointed a Special Technology Advisor to enhance the Fund's expertise in the technology sector. Each of them will become the mentor of at least one of the Fund investee companies, adding not only their managerial expertise but also their network of contacts.

VI. Major issues

- 6.1 Some of the most common issues that investment funds face are:
- Economic factors. There can be no assurance that local economies will not suffer weaknesses;
 - Currency Risk. The Funds will be exposed to foreign currency exchange rate risk. Market rates of exchange are influenced by many factors that neither the managers nor the Funds can control; and
 - Exits. Exiting the Funds' investments may be troublesome in light of the illiquid and early stage nature of the portfolio.

VII. Action Plan

- 7.1 The following is a preliminary schedule for the project's approval process:

Abstract	February 2004
CESI	February 2004
Due Diligence	March-April 2004
Donors	May 2004