

Project Abstract

1. Basic project data

Country:	Chile		
Project Name/Number:	Seed Capital Facility (TBD)		
Project team:	Claudio Cortellese (MIF), Team Leader, Valentina Sequi (MIF), Patricio Diaz (COF/CCH), y XX XX (LEG)		
Date of Request:	December 2003		
Beneficiary:	Seed-stage business or those undergoing restructuring		
Executing Agency:	Fundación Chile		
Financing Plan:	MIF – Facility III-a	US\$	400.000 (50%)
	Local counterpart	US\$	<u>400.000 (50%)</u>
	TOTAL	US\$	800.000 (100%)
	MIF – Facility III-b	US\$	3.000.000 (50%)
	Local counterparts	US\$	<u>3.000.000 (50%)</u>
	TOTAL	US\$	6.000.000 (100%)
Fechas Tentativas	Office of Vice-President: July 30, 2004		
	Donor Committee: September, 2004		

2. Background

- 2.1. The creation of a new enterprise and the development of a new business are complex processes that challenge the entrepreneur to overcome significant obstacles and find creative solutions. In developing countries, specialized support services for up-and-coming entrepreneurs are limited in their number as well as in their level of sophistication and the diversity of their offering. In addition, the lack of well-functioning markets and their limited transparency further increase the barriers to entry of any new business, increasing the complexity and cost of launching a new venture.
- 2.2. Two main requirements are critical for the development of any new enterprise: (a) the availability of financial products tailored to each stage of the venture's development; and (b) the access to support services and networks that can assist the entrepreneur in the launch of his business.
 - a. Small business financing chain
- 2.3. There are various ways to classify the development of an entrepreneurial venture. The following diagram schematizes one approach:

Phase	I Development of Idea	II Research and Development (R&D)	III Technology Application and Initial Business Development	IV Business Growth	V Business Expansion
Timing	1-6 Months	1-5 Years	Years 1-2 of Operation	Years 2-5 of Operation	After 6 th Year of Operation
Financing Method	Friends, Family and Fools	R&D Funds (Angel or Govt.)	Seed Capital	Venture Capital	Private Equity

- 2.4. For the most part, start up companies obtain funding for R&D activities from public sources because the high degree of risk rules out essentially all private investment at this stage of the company's development. Chile has well-developed publicly-run programs that provide grants to companies carrying out R&D activities, such as CORFO's Fondo Desarrollo e Innovacion and FONTEC programs, partially financed by bank loans.
- 2.5. At the same time, Chile has experience in the private equity and risk capital funds (MIF is an investor in some of them) that can be considered a strong base for a growing Venture Capital (VC) industry. The ongoing project that the MIF is carrying out with CORFO will support the expansion of this industry, considering it will lead to the creation of 5-7 new VC funds with a range of industry focuses, investment philosophies etc.
- 2.6. The financing "chain" is broken, however, for companies who, despite having a proven technology, do not have the resources required to turn that technology into viable businesses. These are companies we classify as being in Phase III, Seed Stage, and who need support in developing their business concept and establishing a production, sales and management infrastructure that can implement the strategy.
- 2.7. Phase III companies are not potential targets for VC funds in Chile (nor in any other emerging market) because they lack a proven business model and a track record of sales which makes them too risky for VC investors.

b. Small business support network

- 2.8. One of the main problems that start-up companies, especially those belonging to the technology sector face is their weakness in the areas of strategic and operational management. While these entrepreneurs have a great deal of technical know-how, they lack the business skills to take their companies through to the next level of growth.
- 2.9. In Chile, the most common source of support to new entrepreneurs are incubators associated with Universities. There are 13 such incubators in Chile, all of them recently formed, but with differing levels of development. The first incubator,

Access Nova, associated with the University of Chile, was created in 1996. Some of the incubators, such as the OCTANTIS program of the Adolfo Ibáñez University, benefits from the participation of private companies who provide some, albeit marginal, financial support. These private companies do, however, provide the incubated companies with critical networks of commercial contacts.

- 2.10. Another source of support for early-stage firms comes from Fundación Chile's Technological Center which has developed a methodology to support the businesses associated with the United Nations EMPRETEC program (Programa Internacional de Desarrollo Empresarial). EMPRETEC provides practical tools to help entrepreneurs manage their businesses, improve their sales functions and market their innovations.
- 2.11. Finally, there exist a few private sector actors that support entrepreneurial ventures, most important of which is the Endeavor program. Through a highly demanding screening process, Endeavor identifies promising entrepreneurs and through this brings them to the attention of the business community as well as to potential investors.
- 2.12. With the exception of University-linked incubators, some support by Endeavor of a very small number of selected entrepreneurs, and Fundación Chile's Technological Center – which until now has mostly limited itself to the specific area of technology transfer – there are few alternatives for new entrepreneurs to access specialized services to support their new businesses.
- 2.13. It is even more difficult for new entrepreneurs to access the business networks of business contacts which are so important for the commercial development of any business, particularly in a small economy where access to international markets is critical. More importantly, the few initiatives that exist, even if they are steps in the right direction, are dispersed, not properly integrated among each other, and are only accessible to those companies linked to the sponsoring institution (University etc.).

c. Project justification

- 2.14. International experience shows the critical role that managerial skills play in the probability of success of an entrepreneurial venture. It is furthermore extremely important to complement the provision of entrepreneurial training services with access to business networks. It would therefore make a very strong impact if both the providers of these specialized entrepreneurial support services and the networks of business people that can provide support to up-and-coming entrepreneurs, could be organized into an easily accessible and coherent network. Individuals such as business angels, who are searching for new opportunities to finance and support, could also be associated to this initiative for their own benefit as well as for the benefit of the young entrepreneurs.
- 2.15. MIF can have a catalytic role in the development of these seed stage firms. Its resources can allow the creation of a very innovative vehicle that can finance new

businesses, attracting the resources of wealthy individuals and mature businessmen to the benefit of those entrepreneurs. It can also play this catalytic role in supporting the coordination of the different initiatives present in the market that aim at supporting the commercial development of new businesses.

- 2.16. This project may be considered one of the first in the new cluster of projects *Supporting Early Stage Dynamic Companies*, since it has been designed to include a seed financing vehicle together with value-added services to new ventures.

III. Program objective and description

- 3.1 The general objective of the project is to generate a demonstration effect that will encourage institutions and investors to finance and support enterprises whose phase of development puts them in between the technology development (R&D) stage and the more mature productive expansion of their business.
- 3.2 The purpose of the project is the creation of a Facility that will invest in Seed stage, Phase III (as previously defined) technology based and high growth potential companies. This Facility will also provide business support by participating as an active partner in the management of the start-ups and by facilitating access to different sources of technological business development services (second component).
- 3.3 The proposed project will serve as a link that can take those companies that have successfully passed the R&D stage, to the point where they have the business infrastructure to become interesting targets for VC investment. The Facility will contribute vital management know-how to these companies in order for them to reach their objectives. In this way, this project will complement the MIF initiative in Chile aimed at creating a vibrant Venture Capital industry.

a. Seed capital financing

- 3.4 The Project proposes to create a financial vehicle which will make equity and quasi equity investments to investee companies in the range of US\$300,000 to US\$500,000. Sourcing of investment candidates will be done not only through Fundación Chile's technology center but also through other incubators affiliated with universities, VC Funds, industry contacts etc. The Facility will have a 6-year life and a 3-year investment period.
- 3.5 The Facility intends to participate in the upside potential of these start-up firms by requiring a call option from each investee company that will give the Facility the right to buy – at any time the Facility chooses – up to a small percentage of the company's shares at the share price at the time the financing was made.
- 3.6 In order to integrate the chain between R&D Funds <--> Seed Funds <--> VC Funds, the Facility intends to incorporate into its Investment Committee players from Chile's VC industry. This will ensure that the VC-perspective is factored

into the decision of which companies to invest in. In addition, private investors and industry experts would also participate in the Investment Committee.

- 3.7 What is being proposed is not a traditional MIF equity investment but a pilot project. In fact the proposed instrument differs in the following aspects: (i) the high levels of risk inherent in Seed-stage investments and the difficulty of quantifying expected returns at such an early stage; (ii) participation of private sector actors - a sine-qua-non for a MIF equity investment- is not expected in this Facility, at least during its early years and before it has achieved a positive track record, but will be required only at the investee company level, on an investment-by-investment basis; (iii) the facility will consider an active role in project selection and development for private sector actors, even as they are not a major investors in the facility; (iv) the MIF role in the Governance will be less active than in most Venture Funds, but will be limited to guaranty transparency in the process of selection of beneficiaries and in management of financial resources.

b. Development of a support network for new entrepreneurs

- 3.8 The project intends to facilitate the development of a network of institutions and other sources of support for new business development. The project will basically focus on two main initiatives: strengthening and coordinating the existing supply of specialized training services aimed at developing entrepreneurial capabilities; and developing business networks to support new entrepreneurs.
- 3.9 Specialized training for new entrepreneurs. The training program under consideration will be developed by a University that will be associated with the project. The project will not duplicate already existing initiatives but rather will complement or improve on them, such as those created by the University Adolfo Ibañez and the University del Desarrollo¹, that have already been identified by the team. The beneficiary initiatives will be selected on the basis of criteria to be defined during project analysis. The methodology will follow best practices in the region and in United States, where numerous programs of this nature are in place. Possible subsidies in special cases will be considered. These courses will focus on the development of concrete business plans and will be a resource to the enterprises supported by the Seed Capital facility.
- 3.10 Business networks. The project will support the building of business and scientific networks and ensure their accessibility for new entrepreneurs. This will expand the networks that have to date been created by Fundación Chile in at least three ways: (i) development of a Business Angel network, that will be a potential co-investor of the facility as well as a provider of business support; (ii) improvement in the access new entrepreneurs have to existing global networks; and (iii) expansion of existing networks, with new partnerships in the region and outside.

¹ The first is in association with Babson College in Boston, and the Universidad del Desarrollo received the support of Dom Cabral, a Brazilian business school which implanted a MIF program aimed at training entrepreneurs to develop export oriented business.

IV. Cost and financing

- 4.1 The Facility will be financed with US\$1.5 million from both MIF and Fundación Chile. In addition, MIF will commit to matching up to an additional \$1.5 million in third party funds especially from private investors that Fundación Chile is able to secure once the Facility shows its first successes.
- 4.2 The second component will be financed through technical assistance, of which MIF's contribution would be US\$400.000, matching an equivalent amount from the counterpart.
- 4.3 The Facility will be sustainable because all eventual gains will be reinvested into it, and, since new partners that contribute additional financial resources can join the Facility over time, the Facility would become a revolving vehicle with no fixed end date. MIF will exit the facility at the end of year 6, from the start of the Facility's operations. To do this, from the end of the investment period, any income to the facility will be distributed to MIF (share to be defined during due diligence).

V. Executing agency and execution structure

- 5.1 The project's executing agency is Fundación Chile, but the Facility will be managed with the active participation of VC Fund managers, private investors and it will carry out some activities in association with Universities.
- 5.2 Throughout its lifetime, Fundación Chile has created more than 60 companies in a variety of industries in Chile. Currently, it has an **Investment and Business** division that is in charge of providing technical, strategic and administrative support in the seed and early development stage of entrepreneurial ventures sourced from its own internal Technology Transfer division. In addition, Fundación Chile has a business unit in charge of developing entrepreneurial skills through the EMPRETEC program, through its association with the Harvard Negotiation program, and through its alliance with UCLA's Executive MBA program².
- 5.3 Fundación Chile has been able to constitute a large and well-recognized network of national and international contacts at the level of private companies, universities, technology institutions and governments. This network of alliances is strongest in those fields where Fundación Chile operates such as Information Technology, environmental technologies, aquaculture and fishing industries, agro industry, ecotourism, and the forestry sector.
- 5.4 Fundación Chile has executed MIF projects with good results. In particular, the "Innovation and Technology Transfer" project (ATN-5444-CH), after a slow

² Fundación Chile has an agreement with the Global Access Program (GAP) of the UCLA Andersen School of Business to prepare business plans of those Fundación Chile projects identified and validated as high-potential businesses. Both institutions have presented to the local IDB office preliminary project ideas to support new entrepreneurs.

start, was successful in financing 23 technology transfer projects (the initial goal was 15).

VI. Major issues

- 6.1. The team will carry out an in-depth analysis of Fundación Chile's capabilities to carry out the tasks needed for the success of this project and will define the specific actions needed to improve them, including the association with third parties to execute some of the activities. The project analysis will also focus on the following aspects: (i) the governance structure of the financial vehicle; (ii) the best partners to develop the second component (support network); (iii) feasibility of developing a local business network and to associate business angels to the project; (iv) defining the criteria for analysis of investee companies, the preferred investment structure, the original elements of contracts, if any; (v) identification any new activity that may be necessary to develop for the success of the project, particularly in the area of the selection of investment opportunities and supporting the development of the investee companies.

VII. Action Plan

- 8.1. The team plans to realize the analysis and due diligence mission in June-July and to present the project to Donors committee in September 2004.

VIII. Environmental and Social Strategy

- 8.1. The characteristics of the potential beneficiary make improbable the support of environmental sensitive business. Even so, the program will adopt the MIF environmental guidelines for all investee companies. It will also promote through proper training of trainers a better knowledge of the importance to analyze the social and environmental aspects of the development of a new business.