PROMOTION OF INVESTMENT IN SMALL BUSINESSES AND STRENGTHENING OF THE VENTURE CAPITAL INDUSTRY

(TC-02-07-02-5/TC-02-07-02-6)

EXECUTIVE SUMMARY

Executing agency: Corporación de Fomento [Production Development Agency] (CORFO)

Project number: TC-0207025 Contingent guarantee liability
TC-0207026 Grant

Beneficiaries: Chilean small businesses

Objectives: The project's objective is to further the development of Chile's venture capital industry, to help small businesses secure access to long-term financing. Specific objectives are to: (i) implement a **pilot program to promote investment in small businesses** through venture capital funds; (ii) develop skills and capacity in venture capital industry operators (Fund managers, attorneys, etc.); and (iii) build management capacity for the **pilot program**.

Financing: FACILITY III –A

MIF:	US$ 400,000
CORFO:	US$ 400,000
Total:	US$ 800,000

FACILITY III-B

MIF:	US$10,000,000
CORFO:	US$12,000,000
OTHERS:	US$ 2,000,000
Total:	US$24,000,000

Exceptions to Bank policy: None.

Environmental and social review: The project was approved by the Committee on Environment and Social Impact (CESI) in its meeting of 11 October 2002.

Description:

A. Guarantee and promotion of investment in venture capital funds. In conjunction with CORFO, the project would implement a guarantee facility to finance the **pilot program for promoting investment in small businesses**, based on supporting the development of the venture capital industry. For this purpose, the Multilateral Investment Fund (MIF) will partially fund CORFO-issued investor guarantees, with a maximum (reserved) commitment of US$10 million, and proposes to seek additional participants to increase this support to US$12 million. The assumption in the program is that each private venture-capital investor will use two different instruments simultaneously: (i) up to two thirds of the investment will be in the form of debt and (ii) at least one third would have to be in the form of equity, bearing the concomitant risks. The program will guarantee the debt portion, both principal as well as an interest rate equivalent to that of government bonds with similar terms and conditions. The guarantee will be tied to the application of rigorous eligibility criteria for the venture capital funds (Funds) (paragraphs 4.09-4.11). Based on the experience of the U.S. Small Business Investment Corporation, potential Fund managers will be carefully selected and supported by appropriate training, and standards will be developed with a view to lowering transaction costs (technical assistance component B). Contractual conditions limiting the guarantors' risk will be included in the Funds' bylaws (paragraph 4.12) and a supervision system will be instituted (paragraphs 4.20-4.22).

The program's size is based on a working hypothesis of seven eligible Funds, each with resources of approximately US$20 million. It was calculated that the operation's financial risk level will make it possible to use a multiple of 4 between resources committed and guaranteed. CORFO will guarantee 50% of the principal and the interest and will take the first losses. The MIF, together with the other participants, will provide resources intended to fund the guarantee (issued by CORFO) of the other 50% of the debt. CORFO will also assume the (very remote) risk of covering losses that exceed the maximum commitment of the MIF and the other participants (paragraph 4.23).

It is expected that it will be possible to set up the Funds during the first three years of the program's operation, counting from the first guarantee issuance, and in any event no more than four years from the date of signature of the MIF-CORFO agreements. Each Fund will have a life span of ten years (eight years extendable to ten). The program is scheduled to run for 11 years, with the possibility of an extension to 13 years.

Costs associated with this guarantee will be paid by the individual Funds and will consist of a commitment fee of 0.5% of the undisbursed

committed amount and a 1.7% guarantee fee on amounts disbursed and actually guaranteed. The MIF and the other participants also will receive a 5% share of the program-supported Funds' earnings in excess of the preferred investors' return.

CORFO will operate the program through a specialized unit (Administrative Unit) whose terms of reference will be devised by an Executive Committee that will include one MIF representative. The MIF and the other participants will operate through a "Representative Entity" which will be in charge of activities needed for the program's implementation, working in concert with CORFO and supplementing that agency's efforts.

Certain decisions regarding the program's operation are to be taken by consensus with the MIF or its representative: the terms of reference and makeup of the program's Administrative Unit; the granting and/or withdrawal of licenses to Fund managers; and decisions related to material events in the conduct of the Funds, such as early liquidation or removal of the Fund's manager.

Returns in this operation are highly sensitive to the ultimate performance of the guaranteed Funds. Furthermore, the nature of the program as an instrument to develop a fledgling industry carries within it the likelihood of a low return rate. Accordingly, recovery of capital plus 7% per annum, which is considered to be the cost of capital, has been considered to be sufficient (paragraphs 4.26-4.29).

B. Support for market operators. This technical assistance component is intended to enhance operators' technical capabilities and know-how related to development of the venture capital industry. The following activities are planned: (i) training for venture capital fund managers; (ii) building of local training capacity, supporting recognized teaching and research centers; and (iii) improving legal-service capabilities and the development of legal instruments. The MIF's contribution will be primarily to transfer knowledge, experience and best practices and help develop specialized course materials.

C. Training and strengthening of the program executing unit. The project would assist in the implementation, within CORFO, of the Administrative Unit for the guarantee program to support the venture capital industry. To this end, the program will finance: (i) activities to publicize the program and raise awareness in the business community; (ii) training for the Unit's staff; (iii) training for CORFO's management; (iv) the definition of methodology and manuals for selecting eligible Funds as well as implementation of an operations supervision system; and (v) final preparation of the program's contractual instruments.

Rationale. Given the obstacles explained elsewhere in this proposal, the rationale for the project is as follows: (i) implementation of an instrument well suited to innovation financing and small business finance, two typical public-policy objectives; (ii) reduced entry barriers for Fund managers (such as Fund management experience) to ease the entry of new players (managers, investors, etc.) and heighten competition; and (iii) lowered investor risks or creation of appropriate incentives that can offset the high transaction costs of such operations for private investors, particularly institutional investors, helping to funnel private money into small business development. Once this program is implemented the MIF would have performed its role of leveraging private funding in Chile and would make no further direct investments in individual Funds. Lastly, the cost of a program of this nature entails a low or zero cost to society, as the SBIC's experience shows (losses of just US$568 million while generating over US$2.7 billion in tax revenues from SBIC funds) (see paragraph 2.21).

Sustainability of the project, especially of the first (guarantee) component, will be assured by the revenues that would come from the instrument itself; i.e., fees and a share of Fund profits. Sustainability of the technical assistance components is based on the project's financing of local capacity building and only partially subsidizing access to the program's training activities.

Monitoring and supervision. The Chile Country Office will be responsible for supervising the project's technical assistance components, and will receive support in the technical elements of this task from Headquarters, and in particular from the Office of the MIF as needed. In regard to the guarantee program, CORFO is to send to the executing agency and the MIF: (a) semiannual reports on the program's execution, including unaudited financial statements of the supported Funds and information on investment performance; and (b) an annual report that considers the audited financial statements of Funds and Managers, together with a summary of the auditors' report.

Evaluation. Using project funds, the Bank will commission three program evaluations: (i) a midterm review following disbursement of at least 50% of the technical assistance resources; (ii) another evaluation once execution of the technical assistance components is completed, and (iii) a final evaluation at the end of the Funds' investment lifespan, i.e., after year 7.

Risks: The operation's chief risks can be summarized as follows:

a. **Macroeconomic and currency risk**. This risk is relatively slight in Chile due to the prudential conduct of the economic authorities, political stability, and the regulations in place. **Considerations**: In

the guarantee component, the project would make only a small initial disbursement to fund the first two years' administrative costs (paragraph 4.8); moreover, much of the guarantee-fee income will have come in prior to any potential losses requiring coverage. Thus, in this context, a devaluation of the Chilean currency would benefit the MIF, since investments in the Funds will be made in local currency.

b. **Insufficient program demand**. This refers to the eventuality that institutional investors might decide not to participate. During the due diligence process it was determined that these investors will consider supporting initiatives such as the one being proposed here provided that no significant risk is involved. **Mitigating factor**: The project would guarantee up to two thirds of the investment, including interest, which is a major incentive. In addition, the project intends to carefully select Fund managers, bring in industry operating standards, and supervise Fund performance, all of which would facilitate the work of a Fund investor without being a substitute for it. The project would also enhance the knowledge of the industry and reduce the risk perception, thereby encouraging institutional investors to invest. In any event, the program's commitment period is four years; if the required demand failed to materialize, the guarantee commitment will be lower than planned.

c. **Insufficient investment opportunities**. The risk here is the establishment of a series of Funds that might fail to locate suitable investment opportunities. **Mitigating factors**: Chile has a number of innovation promotion instruments regularly used by companies in various phases of growth (paragraph 2.09). In addition, through the technical assistance components the project will ensure that there is adequate publicity and raise awareness in the business community. These activities should boost the number of prospective Fund investees. However, it could be the case that entrepreneurs are wary of or unable to do business with institutional investors such as the Funds. Another consideration is that the country's economy is still growing, albeit more slowly than in the last decade.

d. **Financial risk involved in the program.** This risk will depend on the performance of Funds covered in the program. **Mitigating factor**: In addition to careful selection of Fund managers and Fund structuring and supervision, the project provides for the MIF to take only the second-line risk in relation to the principal. Also, the sequence of allocation of each Fund's distributions will favor the debt component (paragraph 4.12), further reducing the risk of loss.

e. **Administrative Unit**. The program's Administrative Unit must be equipped to assume its assigned responsibilities. **Mitigating factor**: Through its technical assistance component, the project will fund both skills training for staff and the development of procedures, contracts and other operating instruments (paragraph 4.42).

f. **Capital market**. The relatively undeveloped capital market aimed at small and medium-sized enterprises as well as its limited size could reduce the Funds' exit alternatives. **Mitigating factor**: To reduce this risk, the project will require Funds to have a sizable portion of their investments in the form of debt or quasi-equity. However, a significant increase in finance sources for small and medium-sized companies by way of the Funds will help propel the business and financing sectors and create more investment opportunities. This will help create a market with potential interest in acquiring equity in companies that have not yet gone public. The Bank is also studying various operations aimed at strengthening this market.