VENTURE CAPITAL AND PRIVATE EQUITY ENERGIZE GROWTH

Kalinka Iaquinto, Rio de Janeiro

It all began in 2003, when Gustavo Caetano, a student of marketing, realized that the market for mobile games in Brazil was nonexistent. With financial support from a friend of his father and in partnership with a developer of mobile games from England, in 2004 he opened Sambatech, a company capitalized at R$100,000. "Because we worked with other people's money, from the beginning our process was transparent," he says. This good corporate governance was rewarded. In 2007, when the company expanded its focus to an Internet platform for video distribution, the company managed to attract R$4.7 million in venture capital from FIR Capital. The result? Growth of 300% since 2008, 50 employees (the oldest is 30), and net income of R$10 million in 2010.

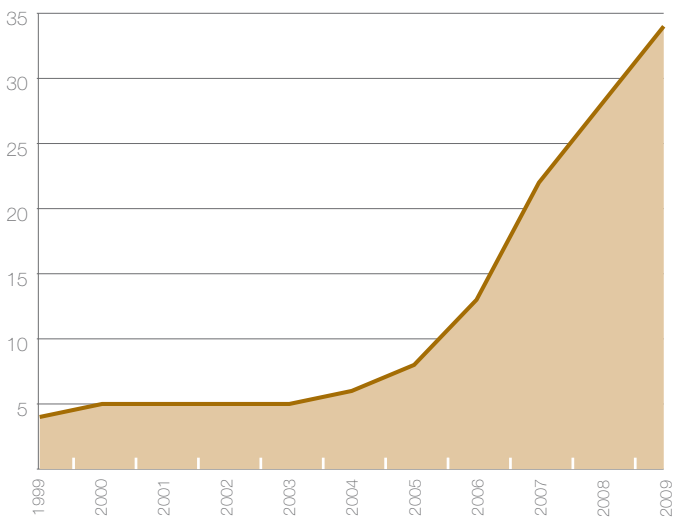
Stories like Caetano's are increasingly common in Brazil: innovative companies with potential for rapid growth have attracted the attention of investment funds that have provided seed capital, venture capital, and private equity to finance their rise. And there is other good news involving this market: negotiations take place in an environment where no specific region predominates, which has attracted the interest of foreign investors who have shifted their radar from the United States and Europe in search of promising economies.

Growth

According to a survey of the Center for Private Equity and Venture Capital (GVCepe) of Getulio Vargas Foundation of São Paulo (FGV-SP), released in April 2010, today in Brazil 140 firms manage financial resources amounting to US$34 billion, 2.2% of GDP. "Our estimate is that over the next five or six years, total investments in private equity will rise to 3.5% or 4% of GDP," says Claudio Furtado, coordinator of GVCepe. The study also reveals good news about the lives of Brazilians. By the end of last year, about 1,700 jobs were created in Brazil with the help of private equity and venture capital, against 1,000 jobs in India and 800 in China.

The economic crisis, which peaked in 2008, has not shaken the morale of the private equity (PE) and venture capital (VC) business in Brazil. On the contrary, it has given impetus to mergers and acquisitions (M&A): in 2006, private equity participated in only 11% of mergers and acquisitions; so far through September 2010, it participated in 43% of this year's 564 M&A transactions. "There has been growth year after year thanks to the presence of well-capitalized

Today in Brazil 140 firms manage financial resources amounting to US$34 billion, 2.2% of GDP.



BOOST FOR BUSINESS

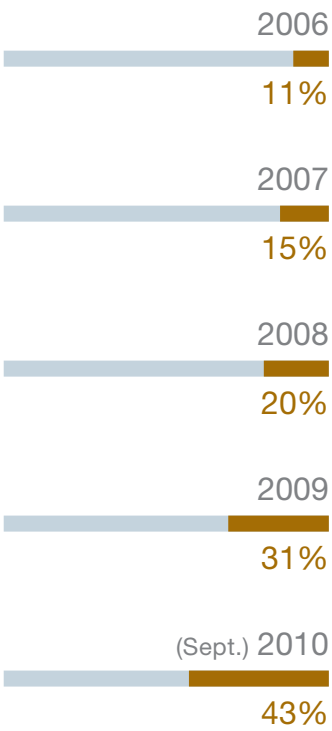
Growth of private equity and venture capital in Brazil

(Billions of U.S. dollars)

Source: ABVCAP.

GROWING SHARE

Private equity's participation in mergers and acquisitions announced in Brazil



Source: PriceWaterhouseCoopers.

private equity firms making investments in sectors with growth opportunities," says Alexandre Pierantoni, a partner at accounting firm PriceWaterhouseCoopers (PWC). And the numbers do not stop there. The GVCepe survey also shows that from 2004 to February of 2010, there were 118 initial public offerings (IPOs), equivalent to R$113 billion. Of these, 41 IPOs were from firms managing private equity (PE) and venture capital (VC) portfolios, representing R$28 billion.

Energizing

Entrepreneur Marcus Regueira, FIR Capital, which manages a fund supported by the government's Financing Agency of Studies and Projects (FINEP), points out that the environment in Brazil is almost ideal for long-term investments like VC and PE initiatives, which generally demand eight to ten years from initial investment to sale. In addition, according to Regueira, the markets in China and India, major investment destinations for PE and VC a few years ago, are inflated: "Brazil has a balanced economy and democracy and a need for investments. Moreover, it has an adequate stock market, which is what those investments look for in public offerings."

Alvaro Gonçalves, founding partner of Stratus Group, is of the view that the PE and VC firms have a special role in the ecosystem of the capital market: as debugger and energizer. He says, "Capital markets in which PE and VC firms operate in a relevant way tend to have a higher level of refinement. They are healthier, less concentrated."

For the entrepreneur, the goal in Brazil is for more businesses to trade on the stock exchange. India is a smaller economy than Brazil, but it has nearly 7,000 public companies, compared to only about 500 in Brazil. "We have the smallest stock exchange in emerging markets, either because we have for a long time lived with high interest rates, or from decades of an investing culture relying on fixed income. And the average entrepreneur still thinks that issuing shares on the stock exchange is only for large corporations," Gonçalves says.

Attraction

The PE and VC business in Brazil has attracted the attention of foreign investors, although 60% of its capital is still concentrated in the hands of domestic investors, according to the GVCepe study. "The business captures a lot of resources from institutional investors, such as pension funds, which are investing less in fixed-income securities so they can allocate more resources to private equity and venture capital options," says Claudio Furtado. According to Sidney Chameh, president of the Association of Private Equity & Venture Capital (ABVCAP), it is now necessary to

attract smaller pension funds to this market to broaden the action.

The difference between investment committed and investment realized is still significant, however: while committed investment is 2% of GDP, investment carried out represents only a tenth of that, 0.2%. In the United States, where the business has existed for at least 30 years, the percentage is naturally much higher at 1.4% of GDP. In India the figure is 0.81% and in China 0.21%. Thus, there is room to grow, since most PE and VC funds are still well-stocked with capital. In addition, Brazil is following a global trend of investment funds broadening their portfolios. Traditional sectors such as construction and real estate are already flirting with these funds. Each accounts for about 13% of the business, as do computers and electronics, followed by agribusiness (6%), energy (7%), communication and media (8%), food and beverages (4%), retail (5%), and biotechnology (4%).

Volatility

Although the VC and PE business is promising, Brazil's volatile exchange rate is identified as an obstacle to long-term investment, a concern that has increased with rumors of an exchange rate war. To work well, the business needs a stable environment, which has been a rare scenario in recent months. Also, the sudden government decision to raise the tax on financial operations (IOF)

OFFICIAL SUPPORT

The development of the private equity (PE) and venture capital (VC) business in Brazil can be attributed not only to private enterprise but also to the support of government agencies, such as the National Bank for Economic and Social Development (BNDES) and the Financier of Studies and Projects (FINEP) of the Ministry of Science and Technology.

In 1996 the BNDES started working with PE and VC firms and now has an important role in supplying venture capital at the intermediate stage between the need for seed capital (start-up) and private equity (to maximize the sale or entry into the stock exchange of a company's stock). The GVCepe study shows that, overall, the volume it has committed in seed and venture capital is low. In 2009 it was approximately US$2.1 billion; this year's forecast is US$2.5 billion.

The BNDES has 40 projects in its PE and VC portfolio in such areas as infrastructure, energy, education, agribusiness, and the environment. There are 158 companies whose approved equity commitment is R$4.6 billion, R$976 million of which is from BNDES and the rest from investor partners. Innovation is the focus of 34% of these funds, followed by infrastructure (27%) and governance (15%). In terms of net worth, the area of infrastructure is most favored, accounting for 57% of the BNDES project portfolio.

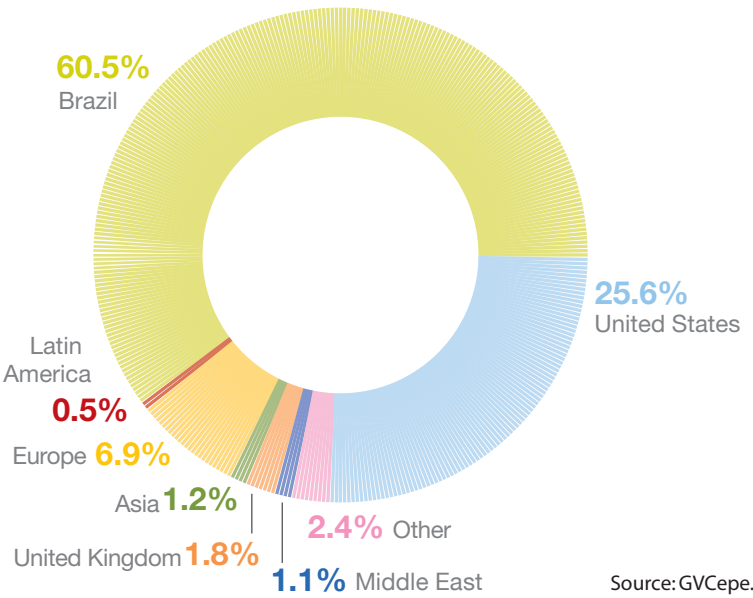
Eduardo Sá, director of the BNDES Funds Investment Department, thinks that Brazil still needs to invest more in start-up companies through "angel investors," successful executives seeking new businesses in which to deploy their capital and experience. "This environment that we seek to promote should happen over time, as entrepreneurship grows in Brazil and so do its profits and success, as occurs in other countries. It's a cultural change," he says.

FINEP has also perceived this change of vision and understanding of entrepreneurship in Brazil. In 2000, FINEP launched the Innovation Program, which is already in the second stages; it supports innovative companies through venture capital operations. In 2006, FINEP launched the Innovation Seed, dedicated to companies that are still in embryonic stage. FINEP superintendent of investments Patricia Davis reckons that its objectives are being achieved: "Today, entrepreneurs already know what it's like to have an investor and a manager in their businesses."

Currently, FINEP has approved 25 funds — 13 venture capital, 7 seed capital, and 5 private equity — of which 18 are in operation and have invested in 70 companies. The total volume of funds is R$3.5 billion, of which R$335 million is from FINEP and is distributed 43% in private equity, 42% in venture capital, and 15% in seed capital.

MOSTLY BRAZILIAN

Sources of funding of private equity and venture capital, 2009



Source: GVCepe.

Brazil's volatile exchange rate is identified as an obstacle to long-term investment, a concern that has increased with rumors of an exchange rate war.

as a way to prevent exchange rate appreciation has exacerbated the concerns. "The problem is that the government included the PE and VC business as among factors that may cause instability of the exchange rate. Currently, you could not make an exception, although there is not a penny of private equity going into fixed income. Private equity capital is investing in the productivity of the country. It helps the industrial base here," Gonçalves says.

Gonçalves argues for exempting the PE and VC business from the new tax. Regueira agrees that the tax "is a very negative variable for the PE and VC business. Private equity flows as a share of GDP are not enough to significantly affect the exchange rate."

"You cannot have on one side people making a major effort to attract private investment and international investors, while on the other people are raising the IOF for the international investor who will be in these funds for ten years. The government has two roles," comments Patricia Freitas, FINEP superintendent of investments.

Despite all the challenges, in discussions about the future of PE and VC in Brazil, the opinion is almost unanimous: the market will grow and there will be new forms of investment funds in different areas. For instance, funds of funds, which allow access to portfolios of a number of investment funds, present an alternative for making the capital market more accessible to small investors interested in diversifying their portfolios.