

# **The Brazilian Venture Capital Industry and its Strategic Role in Closing the Financing Gap of SMEs**

**This discussion paper is a contribution of the Brazilian Government to the 2006 Annual Conference of the OECD High-level Conference on "Better Financing for Entrepreneurship and SMEs" to be held in Brasilia, Brazil on 27-30 March 2006. It has been prepared by The Center for Studies in Private Equity and Venture Capital of EAESP-Fundação Getúlio Vargas under the auspices of ABDI – Agência Brasileira para o Desenvolvimento Industrial – an agency of the Ministry of Industrial Development and Foreign Trade, in cooperation with ABVCAP – The Brazilian Association of Private Equity and Venture Capital**

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## I. INTRODUCTION

This paper examines the role of the Private Equity and Venture Capital industry in Brazil. In particular we describe the financing gap for small and medium enterprises' (SMEs) and the role played by the PE/VC industry in bridging the financing gap that these companies face during their lives.

We address this issue by looking at the determinants of both the supply and the demand for capital for SMEs in Brazil. On the demand side we focus on the formation and growth processes of SMEs. On the supply side we examine the structure and functioning of the Brazilian Private Equity and Venture Capital industry, as well as the government initiatives to foster entrepreneurship and provide risk capital.

In our view, the Brazilian Venture Capital industry holds a strategic position in the financing chain of high-growth SMEs because it has developed the necessary skills to foster innovation and competition. Considering the number of PE/VC management firms operating in the country, their quality, the level of education and experience of their managers, the current stage of market oriented institutions, and the developments of the legal system, the Brazilian PE/VC industry will continue to play a fundamental role in the development of innovative and high tech enterprises in the country.

According to the Global Entrepreneurship Monitor research, Brazil is one of the seven countries with the highest entrepreneurship activity (as measured by the ratio of entrepreneurs to the total population). Even though, most of Brazilian entrepreneurs are *entrepreneurs by necessity*, there is still a considerable number of *entrepreneurs by opportunity*. The high absolute number of entrepreneurs by opportunity suggests a continuous deal flow for the PE/VC industry.

As the *World Bank Investment Climate Survey* (WBICS) shows, credit and other types of financing for SMEs are still quite scarce in Brazil. The existing bank loans are predominantly short term, especially for companies with lack of collateral (characteristics of SMEs). Credit is also scarce due to the high interest rates that have prevailed in Brazil (the second highest in the world). A recent survey of SMEs in the State of Sao Paulo, pointed out that 77% of the entrepreneurs are willing to pay as much as 2% a.m. for loans (600 b.p. above return on the Treasury bills). The banking system charges at least 1500 b.p. above the T-bill rate on receivables-backed trade credit.

Informal businesses in Brazil outnumber legally registered firms by a factor of more than two. In view of this, the number of firms that actually obtain credit (20%) is much lower than the number of firms that actively search for it (51%). Formal credit and professional capital investment are out of the reach of informal companies. As

consequence, bank financing and trade credit represent no more than a third of new businesses' financing. Bank credit and other forms of loans account for meager 3% of SMEs initial funding. Non-bank credit for SMEs is available in the country but to a much lesser extent. Personal funds are by far the main sources for initial capitalization for micro and small businesses. In the course of their existence, internal cash flow generation is the most important source of capital.

Despite the lack of financing, Brazil presents good opportunity for entrepreneurship: The country has (i) large population; (ii) vigorous economy; (iii) high degree of scientific and technological developments; and (iv) considerable institutional development to foster entrepreneurship.

Between 1993 and 2003, the number of newly launched enterprises varied between 445,000 and 533,000 a years. The majority of these new enterprises (80%) are dedicated to retail-trade and services, activities that usually require low capital investments and technology. They are mainly family-owned businesses, with major focus on meeting the basic needs of the population (food, clothing, construction, furniture and personal services). However, a few of the remaining 20% (nearly 100,000 a year) may present potential for adequate forms of seed and early-stage VC investment.

A large number of candidate firms to seed and early-stage investments come from the business-incubator program. This program is experiencing rapid growth in Brazil. The number of active incubators went from 135 in 2000 to a 283 in 2004. A recent assessment of the program shows that more than five thousand SMEs have benefited from this type of support. Most of the incubated companies bring innovation to industries such as software and information technology (25%), electronics (14%), the Internet (11%), biotechnology (5%), telecommunication (4%) and product design (4%). These are most suitable for PE/VC financing and differ from those of companies traded in the Brazilian stock exchanges.

While Brazil has a potential demand for early-stage investment in innovative SMEs, it also has a growing PE/VC industry capable of selecting and financing promising business projects. In the late 1970s and early 1980s the Brazilian government gave the initial push toward outside equity financing for private companies, with operations undertaken by subsidiaries of the National Bank for Economic Development (BNDES). However, the first companies reached by the program were mainly large corporations in traditional strategic industries. Most recently, the focus has changed to high-tech SMEs. In 1994, the government started to phase-out, equity and corporate board participation leaving the manager role entirely to the private sector. This change, which received support from

multilateral institutions and private pension funds, was the first spark in the development of PE/VC vehicles focused on high tech SMEs.

During the past ten years the Brazilian PE/VC industry has evolved significantly. By the end of 2004 there were 71 PE/VC organizations managing US\$ 5.58 billion in 97 investment vehicles. The portfolio was comprised of more than 300 companies of all sizes in 26 different sectors.

For a long time there were concerns about the possibility of Brazilian PE/VC managers completing the entire VC investment cycle. The main weakness was in exiting from investments: 1) the Brazilian IPO market had been inactive since the late 1980s; 2) usually only large firms access the American IPO market; and 3) the burst of the stock market bubble in 2000 caused the American market to be highly selective. This posed a threat to the development of a dynamic PE/VC industry. However, 2004 and 2005 witnessed the rebirth of the Brazilian IPO market: In these two years there were 16 IPOs, 9 of which were of venture backed firms. These 16 IPOs raised nearly R\$10 billion (US\$4.5 billion). The importance of the reopening of the Brazilian IPO market cannot be overemphasized, particularly in view of the extreme underpricing (nearly 7% on average) and high acquisition rates by international investors (nearly 60% on average).

After the completion of the first PE/VC investment cycle, a pool of qualified PE/VC professionals has emerged. There are 498 professionals, of which 233 are partners having long-term commitment to the activity they perform. The group is highly educated (75% passing graduate studies) and experienced (62% work in the industry for more than five years). This group of professionals has become prepared to handle PE/VC challenges in an emerging economy such as Brazil.

While PE/VC constitutes an attractive source of financing, it is obtained by only 1% of all proposed business projects. In 2004 the industry received more than 3,600 investment proposals and invested in 35 of them. During the process, 840 were fully examined by PE/VC professionals and 140 reached the due diligence stage. Only 25% of those underwent the due diligence process received investment in the same year.

In 2004 the PE/VC industry managed a portfolio with 306 companies. Of these, 36 received their first round of PE/VC financing at the seed stage and 72 as start ups. The scant number of investments in PE/VC on seed capital and start-ups may illustrate the initial development of the PE/VC industry in which a small number of venture capitalists managing relatively large funds search for opportunistic investment in well-established firms. One would expect that as the number of venture capitalists increases and opportunities in well-established firms become scarce, the industry will increasingly focus on the development of new businesses. This scenario becomes even more likely when one

considers the growth opportunity for the Brazilian PE/VC industry: while investments in PE/VC represent 1% of the American GDP, PE/VC investment in Brazil is as low as 0.06% of GDP.

The Brazilian institutional environment has also become supportive of early-stage entrepreneurial activity. The recent developments in this area include: (i) a new corporate law; (ii) acknowledgement of arbitration; (iii) a new bankruptcy law (which has opened new avenues for corporate recovery as a substitute for liquidation); (iv) liberalization of pension funds portfolio composition to allow for a quarter percentage of VC/PE investment in their portfolios; and (v) changes in the PE/VC regulation with great emphasis on governance. All this had the effect of augmenting pension funds awareness to and interest in this asset class.

Besides the developments listed above, there are suggestions for improving minority shareholder protection in PE/VC funds organized under the CVM (Brazilian SEC) regulatory framework such as admission of different classes of shares with special voting rights, a plural voting system, and the express recognition in the Brazilian Civil Code of rights typically found in PE/VC investment (tag along, drag along, registration rights and liquidation rights).

There is also room to improve the tax burden on the PE/VC activity in Brazil, and recent changes – MP 281 of Feb. 15, 2006- in tax rules have created a greatly improved environment for venture capital investors. The recent provisional measure (MP 281 of Feb. 15, 2006) enacted by the Federal Government has reduced and equalized capital gains tax rates on VC funds investors.

While tax planning has been used to reduce effective taxation on PE/VC capital gains, this technique has proved itself very costly and cumbersome to PE/VC managers that should be otherwise spending their time in their core activities. The industry needs no tax subsidy; on the contrary, adjustments in tax rules such as equal treatment to foreign investment in all types of long-term mutual funds investments should promote a dramatic increase in the availability of PE/VC funding. This has been the aim of MP 281.

The Brazilian government still plays an important role in the Brazilian PE/VC industry (mainly through the promotion of a stable environment for contract enforcement, reasonable taxation and stable macroeconomic policies). Its role is central, but non-interventionist, leaving the private sector to play the leading role in the PE/VC investment process (selecting investments, adding value to portfolio companies and performing the monitoring and exiting activities in a profitable way to investors).

The Brazilian Government has taken steps to promote equity financing to innovative and technology-oriented projects and start ups. Its several branches (ministries, agencies,

funds, development banks, and state controlled companies) are in the process of coordinating efforts and actions in order to stimulate 1) the creation of technology- and innovation-based SMEs and 2) extend financing to these firms (in partnership with the private sector). Nonetheless, there is still need to set up a more comprehensive investment initiative toward seed, start-up and early-stage innovative and technology-based enterprises.

## **II. VENTURE CAPITAL IN BRAZIL AND THE FINANCING OF SMALL AND MEDIUM SIZED ENTERPRISES**

The Venture Capital and Private Equity industry is notorious for its ability to extend financing to small fast growing technological firms. These firms are also notorious for their importance in promoting technological progress, and generating highly qualified job opportunities. Next, we argue that Brazil presents favorable conditions — entrepreneurial activity, high company building rates, institutional innovation, and political and economical stability — for the development and consolidation of the Private Equity and Venture Capital industry.

### **II.1 ENTREPRENEURIAL ACTIVITY IN BRAZIL: A PERSPECTIVE**

Brazil presents high entrepreneurial capacity. GEM (2004), a 34-country compared study on the Total Entrepreneurial Activity, has Brazil on the seventh position in terms of entrepreneurial activity. The Total Entrepreneurial Activity rate corresponds to the share of the workforce between 18 and 64 years old who wish and are actively performing actions to start a new enterprise, or who already own a business that has been operating for 42 months at most. The same study notes that Brazil has a high absolute number of entrepreneurs. With nearly 15.4 million entrepreneur prospects and/or new business entrepreneurs in absolute figures, Brazil is superseded only by the United States (20.8 million entrepreneurs, according to the same concept).

Also according to GEM (2004), attention should be paid to the high number of *opportunity entrepreneurs* (those motivated by the perception of an opportunity or a little explored market niche) as opposed to *necessity entrepreneurs* (those motivated to open a business due to not finding a reasonable alternative for occupation and income). According to this study, nearly half of the 15.4 million are classified as *opportunity entrepreneurs*. The other half is made up by *necessity entrepreneurs*.

The high entrepreneurial capacity of a country's population, its market size and scientific development are not enough *per se* to actually promote the creation of dynamic



companies capable of promoting robust growth based on high value-added processes. There must also be an institutional development that allows a properly performing financial system to bloom and provide entrepreneurs with the required capital.

On average, nearly 500.000 companies are created every year in Brazil. (DNRC, 2005) Approximately half of them are Sole Proprietorships (companies with only 1 owner) and the other half is made by Limited Liability Enterprises (companies with partners). The share of Corporations, Cooperatives and other type of companies does not achieve 1% of all companies established in any given year.

Most Limited Liability Companies have individuals as partners, and 2-partner limited liability companies are the most common ones (Table 1.11). The presence of other companies as stockholders in new companies occurs at 6% of all new companies at most. In the latter case, the most frequent situation is the creation of a company by large business groups (holding companies) to manage a specific business of the group. (SEBRAE-SP, 2004-a)

Nearly all new companies (99%) are micro- and small-sized, according to the number of employees criterion (SEBRAE-SP, 2004-a)<sup>1</sup>. Nearly 80% of those new companies operate on the trade and service sectors. Their presence is significant on activities with low capital and technology requirements, focusing mainly on companies intended to meet the people's basic needs, such as food, clothing, construction, furniture, personal services etc. Those companies are mostly family-owned, and their management is distinguished by this trait (BEDÊ, 2004). In addition, part of the entrepreneurs does not separate company finances from personal ones, using the company's cash resources to pay for personal expenses and personal resources to pay for company expenses (SEBRAE-SP, 2004).

## **II.2 CORPORATE FINANCING FOR MICRO-, SMALL- AND MEDIUM-SIZED COMPANIES: A DIAGNOSIS**

Brazil has a major deficiency on its corporate financing system. Francisco and Kumar (2005), based on the World Bank Investment Climate Survey<sup>2</sup> (WBICS) database,

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<sup>1</sup> Micro-company: a trade or services company with up to 9 employees, or an industrial company with 19 employees. Small company: a trade or services company with 10-49 employees or an industrial company with 20-99 employees.

<sup>2</sup> The World Bank *Investment Climate Survey* (WBICS) was conducted in 2003, and included 1642 companies from thirteen Brazilian states and nine industrial groups. An important dimension of the survey is the number of small companies represented therein. If company size is determined by the number of employees, 20% of the companies are micro (up to 19 employees), 52% are small (from 20 to 99 employees), and 23% are medium (from 100 to 499 employees). Size can be alternatively determined by sales volume.

show that Brazilian companies intensely use internal resources as a financing source (Table II-1).

**Table II-1**

**Company Size and Sources of Finance: Working Capital and New Investments**

	Working Capital				New Investments			
	Micro 0-19	Small 20-99	Medium 100-499	Large >500	Micro 0-19	Small 20-99	Medium 100-499	Large >500
No. of employees								
Internal funds	44.2	43.3	44.8	41.2	58.7	57.8	54.0	41.0
Bank finance	23.5	28.8	31.9	38.6	16.1	21.8	27.1	39.1
Trade credit	14.2	16.3	13.7	14.2	11.9*	8.6*	6.6*	9.2*
Leasing	0.5	0.9	0.8	0.3	2.2	3.1	3.5	5.0
Informal sources	10.5	5.5	1.8	0.2	4.4	2.4	0.4	0.0
External equity finance	2.7	2.7	4.7	1.8	3.5	3.8	6.0	4.0
Credit card finance	0.8	1.0	0.3	0.0	0.5	0.2	0.2	0.0
Others	3.6	1.5	2.0	3.7	2.7	2.3	2.2	1.7
Total (%)	100	100	100	100	100	100	100	100
Total no. of companies	328	860	373	72	247	716	324	64

Source: Francisco and Kumar (2005), based on World Bank, Investment Climate Survey data – Brazil, 2003.

The ratio of internal funds is more pronounced for fixed capital finance (55% for all companies) than for working capital finance (45% of all companies). The importance of internal funds is more pronounced for micro, small, and medium companies than for large companies. Both the overall reliance on internal funds as a source of finance and the greater use of such source of funds for small and medium companies may be an indirect evidence of financing constraints.

Bank finance is the most widely used external source. Reliance on bank finance is greater for larger companies. Other important external funds are trade credit, and informal sources (specially for working capital finance for micro companies). On the other hand, equity finance plays a minor role as a source of finance for Brazilian companies.

The WBICS also gauged the credit constraint existing for Brazilian companies, asking entrepreneurs about access to bank loans. Such profile is summarized on Table II-2. The proportion of companies that do not have a bank loan is high even among large companies (companies with more than 500 employees). The proportion of companies that have a bank loan increases with size, ranging from 27.1% for micro companies to 58.9% for large companies. For those companies who do not have a bank loan, the vast majority did not even apply for it. The proportion of those who applied and were rejected is larger for small companies.

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According to this criterion, nearly half of the companies are micro, with annual sales under R\$ 1200 thousand. A complete description of this sample can be found in Carvalho (2005) and Francisco and Kumar (2005)

**Table II-2****Access to Credit and Credit Constraints**

Constrained companies correspond to (i) companies that did not apply even though they had demand for a Bank loan, and (ii) companies that had a loan application rejected. Other reasons include: application procedures, collateral requirements, interest rates, corruption, expectations of rejection.

	Company Size			
	Micro	Small	Medium	Large
<b>Total no. of companies</b>	<b>329</b>	<b>860</b>	<b>374</b>	<b>73</b>
Have a bank loan	27.1	31.9	43.9	58.9
Do not have a bank loan	72.9	68.1	56.1	41.1
Total	100	100	100	100
<b>Do not have a loan</b>				
Rejected	12.9	10.2	8.6	6.7
Did not apply	87.1	89.8	91.4	93.3
Total	100	100	100	100
<b>Did not apply</b>				
No need	39.2	44.5	51	53.6
Other reasons <sup>2</sup>	60.8	55.5	49	46.4
Total	100	100	100	100
<b>Total of companies constrained</b>	<b>47.7</b>	<b>40.7</b>	<b>29.7</b>	<b>20.5</b>
Application was rejected	9.4	7.0	4.8	2.7
Did not apply	38.3	33.7	24.9	17.8

Source: World Bank, Investment Climate Survey – Brazil, 2003. Francisco and Kumar (2005).

### III. THE CONSOLIDATION OF THE BRAZILIAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

This section presents a quick overview on the Brazilian Private Equity and Venture Capital (PE/VC) industry. It relies on the *1<sup>st</sup> Census of Private Equity & Venture Capital in Brazil* © database, which was made available by Fundação Getúlio Vargas' PE/VC Research Center (GVcepe). The database contains information on the structure, investment cycle, governance and remuneration of the universe of 71 firms that have offices in Brazil<sup>3</sup> and manage PE/VC, Mezzanine and PIPE investments.

In December, 2004, the Brazilian PE/VC industry included 71 PE/VC managing firms, with a total of 97 investment vehicles, including six firms dedicated to Private Investments in Public Equity (PIPE). The total amount of commitments to Brazil was US\$ 5.58 billion. Commitments rose significantly between 1999 and 2000 (from US\$3.71 to US\$4.95 billion). Between 2000 and 2004 the amount remained relatively stable, at close to US\$5 billion.

Chart 1 reveals fundraising activity between 2000 and 2004. It shows the amount raised each year and the number of vehicles that received commitments in the same year. Figures range between US\$230.00 million and US\$1,258 million, while the number of fundraising vehicles ranges from 14 to 28. This indicates that fundraising activity is highly volatile. Throughout 2000, there was a significant (US\$1.26 billion) increase to funds committed to Brazil. This amount was raised by 19 investment vehicles, and almost entirely by 18 typical PE/VC vehicles. On the other hand, 2003 was a meager year: 14 vehicles raised a mere US\$230.00 million. Amounts raised between 2001 and 2003 were modest and averaged US\$274.50 million/year. In 2004, activity resumed, with US\$762.00 million raised.

While funds raised by PIPE vehicles represented less than 10% between 2000 and 2002, they grew to 30% and 40% in 2003 and 2004, respectively. The good fundraising performance in 2004 may have been influenced by several exits that took place in the stock exchanges. Six out of the eight IPOs that took place in BOVESPA in 2004 were PE/VC backed.<sup>4</sup>

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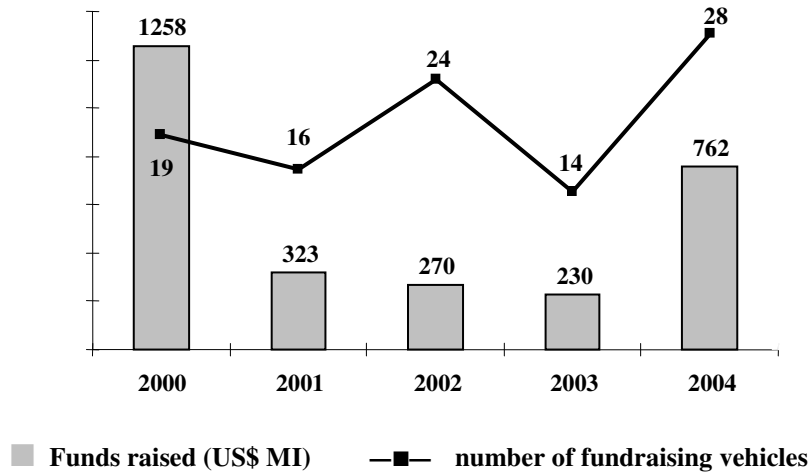
<sup>3</sup> For a complete analysis of the PE/VC industry, readers can refer to the book: Carvalho, Antonio G., Ribeiro, Leonardo L. and Furtado, Cláudio V. *1<sup>st</sup> Census of Private Equity and Venture Capital in Brazil*. FGV Editors, Rio de Janeiro, 2006. Information available at [www.cepe.fgvsp.br/english](http://www.cepe.fgvsp.br/english).

<sup>4</sup> Natura, Gol, ALL, DASA, CPFL, TAM, Grendene and Porto Seguro. Natura received investments from BNDESPar in the form of convertible debt. While TAM was already listed in the stock exchanges, its free float was no more than 1%. Consequently, its 2004 stock issue may be regarded as an IPO.

**Chart 1**

**PE/VC Fundraising in Brazil**

The bars depict the total amount raised annually by new and existing PE/VC and PIPE. The line shows the number of vehicles that were accepting new commitments each year. The figures include the full commitments of Latin American vehicles that did not have a diversification policy limiting the amount invested in a given country (i.e. Brazil).



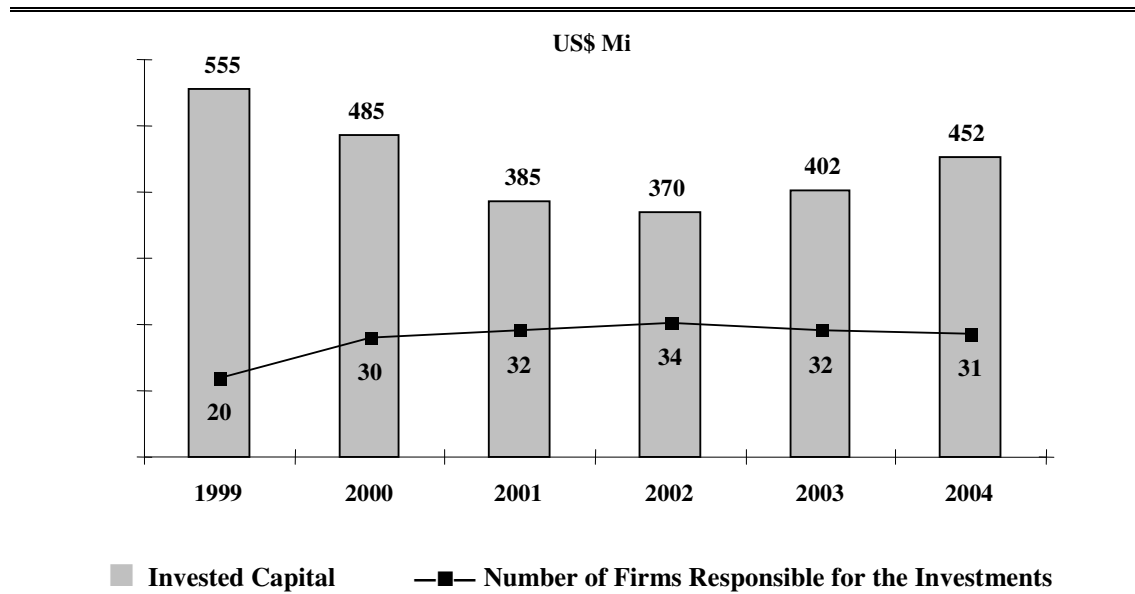
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Chart 2 shows investments made by managing organizations between 1999 and 2004. On average, only about 30 organizations were actively investing each year. Total invested amount ranges from US\$555 to 370 million.

A clearer picture of the industry’s investments arises when we separate PIPE organizations from typical PE/VC ones. The amount invested by typical organizations drops consistently throughout the period, from US\$ 456 to US\$ 253 million, while PIPEs’ investments rise, with a twofold increase in 1999-2004, from US\$ 99 to US\$ 199 million.

## Chart 2 Investment Activity

Investments made annually and number of managing firms responsible for them.



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As a result of PE/VC investments, in December of 2004, 82 out of the 97 PE/VC vehicles<sup>5</sup> had an aggregated portfolio of 306 different firms (or 306 *invested firms*).<sup>6</sup> Out of the remaining vehicles, 14 had not yet begun their investment cycles and only one did not report this information. Because some invested firms received capital from more than one PE/VC vehicle, these 306 firms comprise a total of 357 deals.<sup>7</sup> Table III-1 describes the data and reveals that 264 firms have only one PE/VC shareholder, while a syndicate of PE/VC investors financed 42.

<sup>5</sup> Figure includes PIPEs.

<sup>6</sup> To prevent double counting, managers were asked at a section of the questionnaire to provide information on firms where they acted as independent investors or leading joint investors.

<sup>7</sup> The number of deals per vehicle is the number of firms in which the vehicle made capital injections. As the number of co-investments in a single company is other than 0, the aggregate number of portfolio firms is different from the aggregate number of deals.

**Table III-1**

**PE/VC Deals in the Industry's Portfolio**

Deals in portfolio as December, 2004, classified as syndications and independent investments. Sixteen vehicles, managed by 15 managing organizations, were not considered because they did not have firms in their portfolios.

<b>Investment type</b>	<b>Number of Deals</b>	<b>Percentage</b>
<b>Independent investment</b>	264	73.9
<b>Syndication in which managing firm acted as the leading co-investor</b>	42	11.8
<b>Syndication in which managing firm acted as co-investor</b>	51	14.3
<b>Total</b>	<b>357</b>	<b>100.0</b>

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Table 2 shows how these invested firms are geographically distributed (since the census did not ask the amount invested in each firm, the distribution is merely numerical). Unsurprisingly, the Southeast congregates most portfolio firms, with 64% of the total, followed by the South, with 27%, Northeast, with 5% and Central-West, with 3%. Only one investment has been made in the North.

The portfolio is diversified across many industries. Table III-2 shows this distribution. As in other countries, technology industries comprise the majority of the portfolio: IT and Electronics (30% of the total number of firms), Telecom (9%), Biotech (3%), Medicine and Beauty (2%), etc. Still, there are also investments in less technology-intensive industries such as: Industrial Products and Services (13%), Retail (7%), Food (4%), Entertainment and Travel (4%), Transportation (3%), Textile (3%), Construction and Real Estate (3%), to name a few.

Even in more traditional industries, a great portion of firms that receives PE/VC are innovation-intensive. For example: Industrial Services includes the distribution of maintenance materials with electronic ordering; the Food industry includes restaurant franchises. In the transportation industry, the case of GOL airlines illustrates an innovative business model in a usually traditional industry. But some investments are in traditional industries and do not necessarily reflect major innovations: theme parks, apparel, supermarkets, oil distribution, bookstores, utilities and so on.

**Table III-2**

**Portfolio Companies and Economic Sectors**

Portfolio firms according to their principal economic sector as December, 2004. For firms operating in more than one sector, only the main sector was considered.

<b>Industry</b>	<b>#</b>	<b>%</b>	<b>Industry</b>	<b>#</b>	<b>%</b>
<b>1. IT and Electronics</b>	<b>92</b>	<b>30.3</b>	7.1.Human	7	2.3
1.1.Software	50	16.4	7.2.Vegetable	2	0.7
1.2.Business Process Outsourcing	14	4.6	7.3.Animal	1	0.3
1.3.Internet	8	2.6	<b>8.Financial Services</b>	<b>10</b>	<b>3.3</b>
1.4.IT Machinery and Equipment	7	2.3	8.1.Insurance	2	0.7
1.5.IT Support Services	5	1.6	8.2.Dental Plan	1	0.3
1.6.Commercial Automation	2	0.7	8.3.Credit Cards	1	0.3
1.7.Systems Integration	1	0.3	8.4.Unidentified	6	2.0
1.8.Digital Security	1	0.3	<b>9.Construction/Real Estate</b>	<b>9</b>	<b>3.0</b>
1.9.Retail	1	0.3	9.1.Construction Materials	6	2.0
1.10.Electrical Equipment	1	0.3	9.2.Real Estate Developments	2	0.7
1.11.Security Equipment	1	0.3	9.3.Real Estate Services	1	0.3
1.12.Electronic Parts	1	0.3	<b>10.Entertainment/Travel</b>	<b>9</b>	<b>3.0</b>
<b>2.Industrial Products/Services</b>	<b>41</b>	<b>13.5</b>	<b>11.Agrubusiness</b>	<b>8</b>	<b>2.6</b>
2.1.Steel	7	2.3	11.1.Agriculture and cattle	4	1.3
2.2.Machinery and Equipment	7	2.3	11.2.Machinery and equipment	2	0.7
2.3.Base Industry	6	2.0	11.3.Inputs	1	0.3
2.4.Industrial Automation	4	1.3	11.4.Reforestation	1	0.3
2.5.Automotive	3	1.0	<b>12.Medicine and Beauty</b>	<b>8</b>	<b>2.6</b>
2.6.Chemical	3	1.0	12.1.Pharmaceuticals	3	1.0
2.7. Industrial Laundry	2	0.7	12.2.Medical-Hospital Products	2	0.7
2.8.Industrial Viewing Systems	2	0.7	12.3.Beauty and Health Franchises	1	0.3
2.9.Sterilization	1	0.3	12.4.Medical and Lab Services	1	0.3
2.10.Engineering	1	0.3	12.5.Medical Instruments	1	0.3
2.11.Furniture	1	0.3	<b>13.Power</b>	<b>7</b>	<b>2.3</b>
2.12.Packaging	1	0.3	13.1.Utilities	3	1.0
2.13.Water Treatment	1	0.3	13.2.Production	3	1.0
2.14.Maint. Materials Dist..	1	0.3	13.3.Power Planning	1	0.3
2.15.Ceramic	1	0.3	<b>14.Textile</b>	<b>7</b>	<b>2.3</b>
<b>3.Telecom</b>	<b>28</b>	<b>9.2</b>	<b>15.Communication/Media</b>	<b>7</b>	<b>2.3</b>
3.1.Services	21	6.9	<b>16.Logistics/Distribution</b>	<b>7</b>	<b>2.3</b>
3.2.Equipment	7	2.3	<b>17.Education</b>	<b>3</b>	<b>1.0</b>
<b>4.Retail</b>	<b>21</b>	<b>6.9</b>	<b>18.Incubator</b>	<b>3</b>	<b>1.0</b>
<b>5.Food</b>	<b>12</b>	<b>3.9</b>	<b>19.Household Appliances</b>	<b>2</b>	<b>0.7</b>
5.1.Food	10	3.3	<b>20.Holding Company</b>	<b>2</b>	<b>0.7</b>
5.2.Fast-food and Franchises	2	0.7	<b>21.Mining</b>	<b>2</b>	<b>0.7</b>
<b>6.Transportation</b>	<b>11</b>	<b>3.6</b>	<b>22.Call Center</b>	<b>1</b>	<b>0.3</b>
6.1.Airlines	4	1.3	<b>23.Shoes</b>	<b>1</b>	<b>0.3</b>
6.2.Railways	4	1.3	<b>24.Security Equipment</b>	<b>1</b>	<b>0.3</b>
6.3.Terrestrial	2	0.7	<b>25.Auctions</b>	<b>1</b>	<b>0.3</b>
6.4.Maritime	1	0.3	<b>26.Sanitation</b>	<b>1</b>	<b>0.3</b>
<b>7.Biotechnology</b>	<b>10</b>	<b>3.3</b>	<b>Unspecified</b>	<b>2</b>	<b>-</b>
		<b>Total</b>			<b>306 100.0</b>



Table III-3 shows the development stage at which firms received their first PE/VC investment. Two thirds of the aggregate portfolio can be considered as typical venture capital investments (204 out of 306 firms). Thirty-six (11.8%) of these are classified as seed capital while 74 (24.2%) are start-ups and 96 (31.4%) were aimed at the expansion of an existing business.

There are 102 (33.3%) typical Private Equity investments. Forty-two (13.7%) of these took place when the invested firm was at a later stage of its development. Other firm-maturity stages, such as acquisition finance, bridge finance, turnaround, mezzanine and management buy-out/buy-in comprise less than 10% of the number of investments. Finally, PIPEs (investment in publicly quoted firms) include 43 firms (14.1%).

**Table III-3**

**Stages of Investments in Portfolio Firms**

Distribution of the portfolio firms, in December, 2004, according to their stage at the time of the first investment. Stages are defined as follows: *Seed capital*: Small investment done at a pre-operational stage to develop an idea for a project or to research markets and file patents. *Start-up*: Investment in a firm at during the first years of operations, when it still does not market products/services. At this stage, firms are already hiring staff and have carried out all the studies required to implement their business plans. *Expansion*: Investment that is usually used as working capital for the expansion of a firm that already markets its products/services. The financing may also be intended for the expansion of new and existing plants or the distribution network. Investments in marketing are also considered. *Later stage*: Firms at this stage have already reached relatively stable growth rates and positive cash flows. *Acquisition Finance*: Investment to finance the acquisition of a third firm. This category includes mezzanine, which combines debt and equity. *Management buyout/in*: Funding the acquisition of a company by a team of internal or external managers. *Bridge finance*: Investment to bring a company to the stock market within one year. May also include the restructuring of significant shareholders' positions. *Turnaround*: Funding provided to a firm in operational and/or financial trouble. *PIPE*: Investment in low-liquidity shares of publicly traded firms.

Stage	Number of Firms	Percentage
<b>Venture Capital</b>	<b>204</b>	<b>66.7</b>
Seed capital	36	11.8
Start-Up	72	23.5
Expansion	96	31.4
<b>Private Equity</b>	<b>102</b>	<b>33.3</b>
Later stage	42	13.7
Acquisition finance	5	1.6
Management buyout/in	3	1.0
Bridge finance	1	0.3
Turnaround	6	2.0
Mezzanine	2	0.6
PIPEs	43	14.1
<b>Total</b>	<b>306</b>	<b>100.0</b>

\*includes 2 mezzanine-type investments

The relatively low number of firms that received seed capital indicates that, despite the fact that there is some managerial experience in doing deals in this early stage of business development, there is still much room of gains from funding startups. In fact, there were virtually no investment vehicles exclusively dedicated to funding firms at this stage.

In Brazil, the government has taken steps to promote the creation and venture financing of SMEs. On the hand, there are 283 business incubators in Brazil (ANPROTEC, 2004). Most of the 2,114 incubated companies are technology driven. In fact, nearly 60% of the working area at those incubators is used by companies in the following sectors: IT and software (25%), Electric and Electronics (14%), Internet (11%), Biotech (5%) and Telecom (4%). Almost 3.000 companies have already left the incubation program (graduated) or still benefit of it indirectly (associated).

On the other hand, the government has started to invest in PE/VC vehicles as a *Limited Partner*, specially in those vehicles directed to typical venture and seed deals.

Finally, Table II-4 shows the industry's exit history. It is important to understand that the number of deals differs from the number of firms: firm with two PE/VC investors are treated as two deals. The years 2001 and 2002 experienced a large number of write-offs, quite possibly due to the investments generated by the large number of new commitments in 2000 (q.v. Chart 1). The year 2004 marks the beginning of the first IPO divestment cycle and may, therefore, be taken as the beginning of the industry's mature stage, as it demonstrates the ability to carry out a complete PE/VC cycle in the image of more developed economies.

Table III-4 lists all of the IPOs done in 2004 and 2005. Out of seven IPOs in 2004, five were PE/VC backed. Also in 2004, 76.7% of the funds raised in Brazil by public offerings (including primary and secondary issues) went to firms funded by the PE/VC industry. Table III-5 shows that the nine of the IPOs (of which seven were partial and two were full exits) amount to just 21.4% of the total 42 exits. The trade-sale mechanism still prevails, at 35.7% of all cases. Unfortunately, detailed information on these transactions is not public and, as a result, we are not able to incorporate this data into our study or measure the performance of PE/VC investments in Brazil.

**Table III-4****Exits**

Number of exits performed annually by each exit route. *Full exit* means the sale of all shares pertaining to the PE/VC vehicle or a complete liquidation of all assets of a given portfolio company. Where exit took place by means of several partial exits, the last transaction is regarded as a full exit and all prior ones as partial exits. *IPO*: initial public offering. *Trade-sale* means the sale of all the stock to one strategic buyer, generally an industrial group interested in incorporating the firm either vertically or horizontally. *Secondary sale* means the sale of the shares to another temporary investor. *Buyback* means the repurchase of stock by the business owner or entrepreneur. *Write-off/down* means full liquidation of the firm's asset and implies termination of operations. *Secondary market sale* means the sale of publicly-traded stock. Does not include PIPEs.

Exit Mechanism	Year					
	1999	2000	2001	2002	2003	2004
<b>Full Exits</b>						
<b>IPO</b>	-	-	-	-	-	2
	-	-	-	-	-	(6.5)
<b>Trade-sale</b>	4	13	8	6	6	15
	(57.1)	(39.4)	(21.6)	(24.0)	(27.3)	(48.4)
<b>Secondary-sale</b>	-	16	1	1	4	2
	-	(48.5)	(27.0)	(4.0)	(18.2)	(6.5)
<b>Buyback</b>	3	1	8	3	9	8
	(42.9)	(3.0)	(21.6)	(12.0)	(40.9)	(25.8)
<b>Write-off/down</b>	-	3	20	15	3	4
	-	(9.1)	(54.1)	(60.0)	(13.6)	(12.9)
<b>Total</b>	<b>7</b>	<b>33</b>	<b>37</b>	<b>25</b>	<b>22</b>	<b>31</b>
<b>Partial Exits</b>						
<b>IPO</b>	-	-	-	-	-	7
	-	-	-	-	-	(63.6)
<b>Secondary-sale</b>	1	2	4	3	1	2
	(100.0)	(66.7)	(66.6)	(60.0)	(50.0)	(18.2)
<b>Buyback/Amortization</b>	-	1	2	2	1	2
	-	(33.3)	(33.3)	(40.0)	(50.0)	(18.2)
<b>Total</b>	<b>1</b>	<b>3</b>	<b>6</b>	<b>5</b>	<b>2</b>	<b>11</b>
<b>GRAND TOTAL</b>	<b>8</b>	<b>36</b>	<b>43</b>	<b>30</b>	<b>24</b>	<b>42</b>

**Table III-5****Bovespa Listing: Issuers and PE/VC Investors**

IPOs in the stock markets between 2004 and 2005. Natura received investment from the BNDESPar in the form of convertible debt. While TAM was already quoted in the stock exchanges, its free float was no more than 1%. Consequently, its 2004 stock issue may be seen as an IPO. Figures in parentheses indicate percentage of the total. Based on BOVESPA data and IPO prospectuses.

<b>Year</b>	<b>Firm</b>	<b>Volume US\$ M</b>	<b>PE/VC Investors</b>
2005	Banco Nossa Caixa	419	
	Cosan	350	
	Energias do Brazil	354	
	Localiza	108	CSFB Private Equity
	OHL Brazil	212	
	Renar Maçãs	6	
	Submarino	176	GP Invest.; Warburg Dillon; TH Lee Putnam; Santander; JP Morgan and Flatiron
	TAM	225	CSFB and Bassini, Playfair and Wright
	UOL	267	Latintech
<b>Total 2005</b>		<b>2.117</b>	
<b>Total PE/VC Invested Firms</b>		<b>776</b>	
2004	ALL	189	GP Invest; CSFB; Electra and GEF
	CPFL	287	Bradespar
	DASA	158	Pátria; JP Morgan and Flatiron
	Gol	283	AIG Capital Partners
	Grendene	216	
	Natura	243	BNDESPar
	Porto Seguro	136	-
<b>Total 2004</b>		<b>1.512</b>	
<b>Total PE/VC Invested Firms</b>		<b>1.160</b>	

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In this section we have developed elements to show that the Brazilian PE/VC industry is capable of reaching a relevant scale and contributing to close the financial gap Brazilian SMEs face. We have presented data showing that 1) there is considerable entrepreneurial talent and activity in the country, 2) that there is strong finance gap for small and medium firms what makes of PE/VC an attractive source of capital; and 3) that the Brazilian PE/VC industry presents conditions to achieve significant scale, namely, investment experience, increasing reputation and a history of exits with some successful transactions that took place in the form of IPOs and trade-sales.

## IV. THE ORGANIZATION AND SUSTAINABILITY OF THE BRAZILIAN PE/VC INDUSTRY

### IV.1 THE PLAYERS IN THE PE/VC INDUSTRY IN BRAZIL

#### IV.1.1 MANAGING ORGANIZATIONS

##### IV.1.1.1 ROOTS AND CONFIGURATION

As seen in Table IV-1, both numerically and in terms of committed capital, the industry is mostly made up of independent organizations or captives of financial institutions. Table IV-1 also shows that the Government plays a role as a direct PE/VC, which is relatively limited since BNDESPar's commitments amount to under 3% of the industry's capital. However, as will be discussed further, the number of firms in BNDESPar's portfolio by December, 2004, was more than 10% of the industry's aggregate portfolio firms. It is also noteworthy that the public sector plays a significant role as an investor (LP) in several investment vehicles.

**Table IV-1**

#### **Managing Firms' Affiliation**

Distribution of managing firms with offices in Brazil by affiliation and committed capital amount in December, 2004. Figures in parentheses stand for percentage of the total. Figures reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate. Does not include commitments of three small-sized vehicles/organizations that did not provide these data.

<b>Affiliation</b>	<b>Number of organizations</b>	<b>Commitments in US\$ billion</b>
<b>Independent organizations</b>	45 (63.4)	2.99 (53.4)
<b>Captives of financial institutions</b>	20 (28.2)	2.11 (37.9)
<b>Industrial concerns (<i>Corporate ventures</i>)</b>	4 (5.6)	0.33 (6.0)
<b>Public sector</b>	2 (2.8)	0.15 (2.7)
<b>Total</b>	<b>71</b> <b>(100.0)</b>	<b>5.58</b> <b>(100.0)</b>

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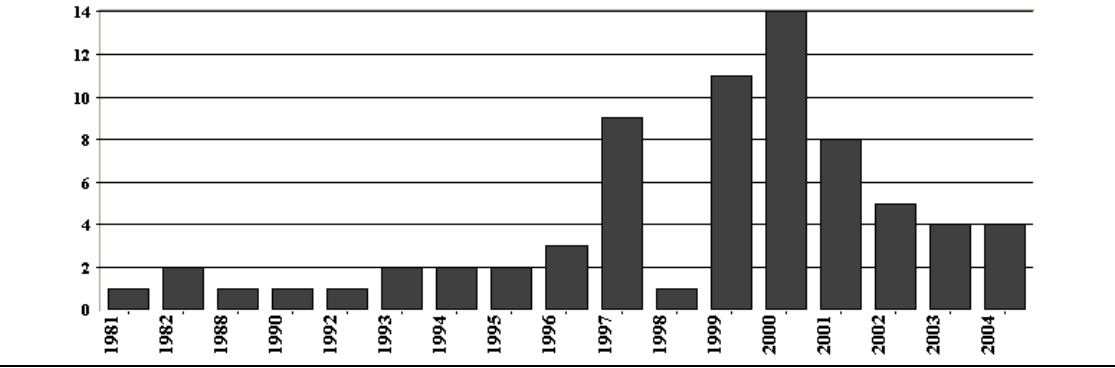
The overwhelming majority of PE/VC managing firms that have offices in Brazil — both numerically and in terms of committed capital — are domestic. The 53 domestic organizations (75%) manage US\$3.54 bi (63% of committed capital). The United States appear as the second most frequently mentioned source of funds: 10 organizations (14%), managing US\$1.76 bi (32% of committed capital). Therefore, Brazil and the United States are the sources of funds for organizations that answer for 95% of all the PE/VC committed capital in Brazil.

Chart 3 depicts the early history of managing firms’ operations. This analysis is imperfect, as it omits institutions that terminated operations before the survey. However, it provides a good historic view of the formation of Brazil’s PE/VC. Note that: a) PE/VC activity in Brazil dates back to the early 1980s — long before the American PE/VC model became an international standard; b) the PE/VC cycle in Brazil starts in earnest after the mid-1990s and picks up momentum after the country’s economic stabilization, begun in 1994; c) entry of organizations was interrupted in 1998, probably due to anticipation of the foreign-exchange regime changes i.e. devaluation in early 1999 and the Russian crisis of 1998; d) the great expansion experienced 1999-2001 is substantially related to cheaper domestic assets in U.S. Dollar terms and to the New Economy’s speculative bubble. The expansion period climaxed in 2000, when 14 organizations entered the market; e) Since 2002, the entry rate has been stable, with about four new managing firms per year.

**Chart 3**

**Start of Activities in Brazil**

Distribution of managing firms with offices in Brazil by year when they commenced operations in Brazil. Does not include organizations that were terminated or left the country before December, 2004.



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Out of the 71 managing firms that make up this study’s population, 55 were actively pursuing new investment opportunities in December, 2004 (referred to as active), while the other 16 had stopped prospecting investments and merely managed their existing portfolios (referred to as inactive). Out of inactive firms, seven indicated plans to leave the industry

and one was undecided, while the other eight stated that they intended to resume activities in the future. The 55 active organizations answer for about 78% of committed capital. Adding the eight inactive organizations that plan to resume activities, we conclude that 63 out of 71 organizations present in 2004 (responsible for 89% of committed capital) intend to remain in the industry. This low (11%) abandonment rate suggests that the industry remains attractive for investment.

The 71 PE/VC managing firms present in Brazil have offices in ten cities, as depicted in the following table (Table IV-2). Organizational headquarters are significantly concentrated in São Paulo: 47 organizations (66%), with US\$4.45 billion in commitments (80% of total commitments). This suggests the establishment of a PE/VC cluster. An even clearer indication of concentration is the fact that the region comprised by avenues Faria Lima and Berrini houses 29 managing organizations, with US\$3.73 billion in commitments (67% of committed capital). Rio de Janeiro is the second most important center, with 19 organizations (27%) and 19% of the committed capital.

Rio de Janeiro gathers important investors (e.g., the PREVI, PETROS and FAPES pension funds), government organizations responsible for fostering the PE/VC market (e.g., FINEP and BNDES) and even the headquarters of the Brazilian Private Equity and Venture Capital Association (ABVCAP), which makes it an important city for the industry. Taken together, São Paulo and Rio de Janeiro are home to 66 of the 71 managing organizations (close to 99% of all PE/VC capital in Brazil). As will be discussed in further detail, this is not to say that the capital is invested proportionally in firms in those regions as compared to other cities and states. The mere fact that these 66 organizations have offices in four of the five Brazilian macro-regions (South, Southeast, Northeast and Center-West) is evidence of an interest in a certain level of regional diversification. This diversification, however, is still limited, since the Northeast has only two offices and the North has none.

**Table IV-2**

**Geographic Presence of PE/VC Management Firms**

Regional distribution of PE/VC managing firms' offices and committed capital amounts by year-end, 2004. Figures in parentheses are percentages of the total. Amounts reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate. Some figures were omitted to prevent identification of confidential information (*n.av.* means *not available*, *n.ap.* means *not applicable*). Total committed capital includes undisclosed amounts. Total offices includes headquarters and secondary offices. Firms with ZIP codes beginning with 045 or 0145 have been grouped into the region comprised by avenues Faria Lima and Berrini. ZIP codes beginning with 013 belong to the Av. Paulista region. Due to its structure BNDESPar was treated as two distinct organizations. Companies with separate PE/VC and PIPE departments were also counted twice. Does not include commitments of three small-sized vehicles/organizations that did not provide these data.

Home City	Number of Organization Headquarters	Total Offices	Commitments in US\$ billion
Brasília	0	3 (3.0)	n.ap.
Recife	0	2 (2.0)	n.ap.
Petrópolis	0	1 (1.0)	n.ap.
Belo Horizonte	1 (1.4)	4 (3.9)	n.av.
Campinas	1 (1.4)	1 (1.0)	n.av.
Curitiba	1 (1.4)	4 (3.9)	n.av.
Florianópolis	1 (1.4)	1 (1.0)	n.av.
Porto Alegre	1 (1.4)	4 (3.9)	n.av.
Rio de Janeiro	19 (26.8)	27 (26.8)	1.05 (18.7)
São Paulo: City Total	47 (66.2)	54 (53.5)	4.45 (79.9)
Faria Lima – Berrini region	29 (40.8)	n.d.	3.73 (66.8)
<b>Total</b>	<b>71</b> <b>(100.0)</b>	<b>101</b> <b>(100.0)</b>	<b>5.58</b> <b>(100.0)</b>

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In much the same manner as managing firms and committed capital are concentrated in a few cities and subregions, a small number of PE/VC managing firms concentrates most of the capital. Table IV-3 shows that the 15 largest organizations, in terms of committed capital, manage 76% of the industry's capital. The five largest concentrate almost half of the aggregate commitments. This indicates an early, fragmentary industry, where the 15 top firms manage an average of US\$283 million, whereas each of the remaining 56 firms manage an average of US\$ 26 million.



**Table IV-3****Capital Concentration across Managing Firms**

Managing firms grouped by size as measured by committed capital amounts by year-end, 2004. Amounts in parentheses are percentages of the industry's total commitment. Amounts reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate.

<b>Organization groups by size</b>	<b>Commitments in US\$ billion</b>	<b>Average Commitment in US\$ million</b>
<b>5 largest</b>	2.56 (45.9)	513
<b>10 largest</b>	3.61 (64.7)	361
<b>15 largest</b>	4.25 (76.2)	283
<b>Remaining 55</b>	1.33 (23.8)	26
<b>Total</b>	<b>5.58</b> <b>(100.0)</b>	<b>85</b>

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**IV.1.1.2 HUMAN RESOURCES AT MANAGING ORGANIZATIONS**

The PE/VC industry is notoriously modest in terms of the number of practitioners employed directly by managing organizations. In December, 2004, the 71 managing firms had 498 employees, 233 of which were in managing positions and 265 acted as a supporting staff. Managers are those with decision-making power in at least one stage of the PE/VC cycle (fundraising, deal origination, monitoring, exiting, etc.). Support staff includes analysts, controllers, interns, assistants, etc., operating under management oversight. The industry's parsimony is clearly indicated by the fact that there is, on average, less than one staff employee per manager.

Out of 233 managers, 60% are partners. It is important to point out that, in certain cases, it is natural for a firm to have no partners at all. This is the case, for example, where the managing firm is captive of a financial institution or the Government. In these cases, managers are hired as executives. The same applies to certain corporate ventures and international organizations. Twenty-one out of the 71 PE/VC organizations present in Brazil do not have a managing partner. Considering only managers at organizations with managing partners, 76% of managers are partners at their organizations.

PE/VC managers are highly skilled and experienced. Approximately 3.5% have PhDs degrees. Those with master's, MBA or LLM<sup>1</sup> degrees add up to 55%. A total of over 73% have at least some post-graduate work.

As regards their professional background, Table III-4 shows that a large share of managers (36%) come from the financial industry. On the other hand, executives from non-financial companies, whose experience is usually more consistent with the preparation and implementation of business strategies (CEOs, entrepreneurs, consultants and business angels), are more than half the total number of managers. Only 9.5% come from other fields (civil servants, academics, lawyers, etc.).

Based on interviews with managers and a survey of their résumés (usually available from managing organizations' websites), all those that stated that their most relevant prior experience was in government either are or have been with BNDES. Seven of these were then employed at six organizations other than BNDESPar itself. There was an apparent positive externality from the actions of BNDES, producing managers for private-sector PE/VC organizations.

The fact that lawyers are a minor share of the manager population reinforces the perception that managing organizations prefer to retain the services of specialized firms over internalizing activities such as agreement preparation, due-diligence procedures, litigation, etc.

**Table IV-4**

**Managers' Professional Background**

Distribution of managers by previous experience most relevant to their current PE/VC activities.

<b>Previous Experience</b>	<b>Number of Managers</b>	<b>Valid Percentage</b>
<b>Financial Industry / Auditor</b>	83	36.4
<b>CEO / non-financial area Office</b>	47	20.6
<b>Consultant</b>	44	19.3
<b>Entrepreneur</b>	29	12.7
<b>Government</b>	16	7.0
<b>Lawyer</b>	5	2.2
<i>Business Angel</i>	2	0.9
<b>Academia</b>	2	0.9
<b>Unspecified</b>	5	-
<b>Total</b>	<b>233</b>	<b>100.0</b>

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<sup>1</sup> LLM, from the Latin *Legum Magister*, is a one-year Master of Law program, and equivalent, in the legal profession, to an MBA in Administration.

Although there are managers with sound experience in the area (9% of managers have more than 17 years' experience in the industry), most (74%) have been in the industry for less than 8 years. This reflects the great cycle of entries and growth the PE/VC industry experienced in the 1990s. Interviews revealed that some managers have amassed PE/VC experience abroad and others included their experience as angel investors. As a consequence, the experience managers have had may not be directly correlated with the entry of managing organizations into the Brazilian PE/VC market.

#### IV.1.2 INVESTMENT VEHICLES

PE/VC managing organizations' activities consist in managing one or more investment vehicles. These vehicles can be structured in various ways. In December, 2004, the 71 managing organizations present in Brazil were responsible for a total of 101 investment vehicles. We were able to get information on almost all of them: 97 vehicles.<sup>2</sup>

Until 1994, holding companies were the most appropriate vehicles for typical PE/VC investments in Brazil. Under Brazilian law, holding companies may exercise management powers, be it by appointing managers or by taking part in the controlled firms' governing bodies (board of administration, audit committee, etc.). On the other hand, when they invest through a holding company, PE/VC investors become shareholders and, therefore, are subject to the laws and regulations applicable to corporations. As a result, the classic divide between investors and managers, with the latter's clearly fiduciary role, is absent. As PE/VC vehicles, holding companies have some shortcomings when compared with LPs, including: 1) taxes on capital gains realized with investment write-offs are owed by the holding company itself, which means that all investors pay at the same tax rate: 34%; 2) they are not established for a limited period of time; 3) they have trouble appropriating tax credits; and 4) they must be publicly traded companies in order to receive investments from foreign investors, with the ensuing costs of a public corporation.

Due to the lack of appropriate vehicles for PE/VC investments in Brazil, the Comissão de Valores Mobiliários (CVM), who regulate the Brazilian stock market, put in place structures closer to LPs through *Instruction CVM 209* of 1994 (which created the FMIEE — *Fundos Mútuos de Investimentos em Empresas Emergentes*) and *Instruction CVM 391* of 2003 (which created the FIP — *Fundos de Investimento em Participações*). These funds, operating as close co-ownerships, are legal structures specifically intended for investing in close corporations. Some of the elements that make holding companies ineffective as PE/VC vehicles are absent from FIP and FMIEE. For example: 1) they can accept investments from eligible foreign investors without having to be publicly traded; 2)

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<sup>2</sup> We obtained no data on a vehicle managed by Darby: Darby Technology Ventures (DTV) and on three vehicles run by J.P. Morgan Partners whose names were not disclosed.

they permit differentiated taxation for quota holders: all the gains produced by the funds are accounted for as capital gains, and taxes are levied when the investors redeem their quotas and pay the taxes owed for their share, at the applicable tax rate. Furthermore, in the event of reinvestment, the taxes are automatically postponed; 3) they can be set up for limited periods of time; 4) they are more flexible as regards tax credit appropriations; 5) it is easier for them to collect management fees; and 6) they benefit from a simpler process when the time comes to liquidate investments. Their main disadvantage lies in the required managerial transparency, which is often undesirable (for example, by being forced to disclose information the managers deem strategic).

An FMIEE (CVM 209) is managed by a natural or legal entity with CVM clearance to manage securities portfolios. Fund management and governance are determined by each fund's peculiar regulations, as approved by simple majority at quota holders' meeting with one vote per quota. FMIEE life spans are limited to a period of ten years, and may be extended once for another five years. Unlike as limited partnerships in the U.S., FMIEE quotas, once paid in, can be admitted into stock exchange or OTC trades upon CVM approval. The number of investors is limited to 35 at most. Each investor must underwrite an amount not under R\$400 thousand.

An FMIEE's investing policy must be formally established by regulation and meet certain minimum CVM requirements such as: 1) investments must be in securities (shares, debentures, warrants) issued by an entity set up as a corporation; 2) target firms must have annual sales under R\$100 million, must not be members of corporate groups with consolidated equity in excess of R\$200 million, and their partners and managers must not include fund managers with a stake in excess of 10% of the capital stock.

*Instruction CVM 391*, which created *fundos de investimentos em participações* (FIP) is another significant landmark for the PE/VC industry in Brazil. As compared to FMIEEs, FIPs: 1) remove the constraints as regards the size of invested firms, which can also be either close or publicly traded; 2) regulate managers' involvement in invested firms' decision-making process; 3) adopt a fund governance model that incorporates investment and technical committees and consultative boards; 4) regulate investment and divestment decision-making processes; 5) require transparency towards quotaholders; and 6) mandate that investment- and quota-valuation accounting rules be set under fund regulations. Contractual freedom for the parties (managers and quotaholders) and automatic registration of FIPs with CVM lend undeniable flexibility to this new PE/VC investment vehicle in Brazil.

PE/VC managers may also establish investment vehicles under the terms of *instruction CVM 409*, of 2004. The several forms of funds standardized by CVM 409

include *fundos de ações* (“stock funds”) used as PE/VC vehicles. These funds must have 67% of their portfolios in securities tradable in stock exchanges or OTC (particularly well-suited for PIPE and mezzanine investments). Investing decisions follow the guidelines of a policy set by quotaholders’ meeting, and the manager is charged with executing deals in securities on behalf of the fund. According to CVM 409, funds may be either close or open, and, in the latter case, are intended only for eligible investors and must file their quotas with the CVM in advance. *Instruction* CVM 409 also stated that funds established under CVM 302 had until December 31st, 2004, to comply with the new regulation (CVM 409). As the survey took place in late 2004, some vehicles were still structured according to the terms of CVM 302.

Table IV-5 groups vehicles by legal structure. Note that LPs have a relatively important weight in the industry. Although they are only 29 out of 97 vehicles (30%), they concentrate 62% of the entire committed capital in Brazil. On the other hand, holding companies, albeit relatively numerous, answer for less than 10% of the capital. Out of the 20 existing holding companies only two are traded in stock exchanges.<sup>3</sup>

Funds established under CVM instructions are the most frequently found: they comprehend 44 vehicles and US\$1.29 billion (23.1% of the industry’s total commitment). Twenty-one are FMIEEs, with US\$170 million in commitments (3% of the capital); 11 are FIPs with US\$620 million in commitments (11.2% of the capital) and 12 are vehicles set up under *Instructions* CVM 302 and 409, with US\$500 million in commitments (8.9% of the capital). Only two CVM funds are traded in stock exchanges.<sup>4</sup>

PIPE vehicles are aligned with the *instructions* CVM. Out of six existing PIPEs, five are structured under *Instruction* CVM 409 and one uses CVM 391.

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<sup>3</sup> Bradespar and Ideiasnet.

<sup>4</sup> *IP.com* funds, established as a CVM 209, and *Bradesco Templeton de Valor and Liquidez*, established as a CVM 409.

**Table IV-5****Investment Vehicles' Legal Structure**

Distribution of investment vehicles according to legal structure of choice. Figures in parentheses are percentages of the total. Amounts reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate.

<b>Legal Structure</b>	<b>Number of vehicles</b>	<b>Commitments in US\$ billion</b>
<b>Limited Partnership</b>	29 (29.9)	3.45 (61.9)
<b>FMIEE (CVM 209)</b>	21 (21.6)	0.17 (3.0)
<b>FIP (CVM 391)</b>	11 (11.3)	0.62 (11.2)
<b>CVM 302 and 409</b>	12 (12.4)	0.50 (8.9)
<b>Holding company<sup>a</sup></b>	20 (20.6)	0.52 (9.4)
<b>Non-financial company division</b>	2 (2.1)	0.31 (5.5)
<b>Other</b>	2 (2.1)	0.01 (0.1)
<b>Total</b>	<b>97</b> <b>(100.0)</b>	<b>5.58</b> <b>(100.0)</b>

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**IV.1.3 FUNDS INVESTORS**

Given their low liquidity, high risk and high expected return, PE/VC vehicles are particularly appealing to investors with great wealth and a lengthy investment horizon — wealthy individual investors, institutional investors (insurance companies and pension funds), trusts and endowments, corporations, bank holdings, multilateral institutions, etc. Given the importance of PE/VC for creating firms, generating jobs and investing in technology and innovation, several countries have been regarding PE/VC as a means to leverage economic growth. As a result, PE/VC investors often include development agencies, multilateral institutions, state-owned banks, etc.

Table IV-6 describes the sources of funds committed to the Brazilian PE/VC industry by investor type. Not surprisingly, institutional investors (i.e., pension funds and insurance companies) make up the leading group, with 22.4% of all committed capital; 39 out of the 97 PE/VC vehicles present in Brazil had at least one institutional investor as quota holder or shareholder.

Upon analysis of the roll of investors, certain details are noteworthy: 1) only 37 vehicles include capital injections from their managers. As there are 45 managing organizations, some managers have not invested in their own vehicles; 2) Public sector funds amount to only 7.2% of commitments, but are spread across 27 vehicles. This denotes the public sector's concern with fostering the PE/VC industry; and 3) there is also little investment from official institutions, at 3% diluted among 19 vehicles, which also shows their concern with encouraging the PE/VC industry.

Table III-6 categorizes the sources of funds as domestic or international. Note, first, that more than 50% of the committed capital in the Brazilian PE/VC industry comes from foreign sources: out of US\$4.29 billion with determined sources, US\$2.54 billion (62%) belong to international investors.

Among *domestic investors*, the most important are institutional, mother organizations, public sector, partners at organizations and individuals not related to the organization.

**Table IV-6**

**PE/VC Investors, Categorized**

Distribution of committed capital by year-end, 2004, by investor class. Amounts reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate. *Number of vehicles* means the number of vehicles with at least one investor in this class. *International official institutions* mean multilateral institutions and foreign government institutions. *Other* includes investor classes with aggregate commitments under US\$60 million: domestic banks, domestic privately-owned firms, domestic PE/VC managing organizations, domestic pension funds, NGOs and holding companies.

<b>Class</b>	<b>Number of Vehicles</b>	<b>Commitments in US\$ billion</b>	<b>Valid Percentage</b>
<b>Institutional investors</b>	39	0.96	22.4
<b>Mother organizations</b>	23	0.61	14.2
<b>Individuals not related to the organization</b>	33	0.41	9.6
<b>Trusts and endowments</b>	7	0.35	8.2
<b>International investment funds</b>	12	0.34	7.9
<b>Government and state-owned companies</b>	27	0.31	7.2
<b>International PE/VC organizations</b>	8	0.28	6.5
<b>International banks</b>	15	0.26	6.1
<b>International privately-owned companies</b>	14	0.23	5.4
<b>Managing organization partners</b>	37	0.19	4.4
<b>International official institutions</b>	19	0.13	3.0
<b>Other</b>	-	0.22	5.1
<b>Unreported</b>	-	1.29	-
<b>Total</b>	<b>-</b>	<b>5.58</b>	<b>100.0</b>

The *main international investors* include: trusts and endowments, investment funds, institutional investors, PE/VC organizations, individuals not related to the organization, banks, privately-owned companies, mother organizations, official institutions and partners at organizations.

**Table IV-7**

**PE/VC Investors by Class and Nationality**

Distribution of committed capital by year-end, 2004, by investor class and nationality. Amounts reported in Reais were converted into U.S. Dollars at the World Bank's average annual rate. *Number of vehicles* means the number of vehicles with at least one investor in this class. *Other* includes: domestic banks, domestic privately-owned companies and domestic PE/VC managing organizations.

<b>Class</b>	<b>Number of Vehicles</b>	<b>Commitments in US\$ billion</b>	<b>Valid Percentage</b>
<b>Domestic</b>			
<b>Institutional investors</b>	26	0.63	36.0
<b>Mother organizations</b>	13	0.40	22.9
<b>Government and state-owned companies</b>	27	0.31	17.7
<b>Individuals not related to the organization</b>	22	0.14	8.0
<b>Organization partners</b>	29	0.10	5.7
<b>Other</b>	-	0.17	9.7
<b>Total, domestic</b>		<b>1.75</b>	<b>100.0</b>
<b>International</b>			
<b>Trusts and endowments</b>	6	0.35	13.8
<b>Investment funds</b>	9	0.34	13.4
<b>Institutional investors</b>	14	0.33	13.0
<b>PE/VC organizations</b>	8	0.28	11.0
<b>Individuals not related to the organization</b>	12	0.27	10.6
<b>Banks</b>	15	0.26	10.2
<b>Privately-owned companies</b>	14	0.23	9.1
<b>Mother organizations</b>	11	0.21	8.3
<b>Official institutions</b>	20	0.13	5.1
<b>Organization partners</b>	10	0.09	3.5
<b>Other</b>	-	0.05	2.0
<b>Total, international</b>	-	<b>2.54</b>	<b>100.0</b>
	<b>Unreported</b>	<b>1.29</b>	
<b>GRAND TOTAL</b>		<b>5.58</b>	

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## IV.2 THE CYCLE OF PE/VC IN BRAZIL

### IV.2.1 INVESTMENT ORIGINATION AND SELECTION

Once fundraising is complete, the investment origination and selection process begins. Three means are used to this end: prospecting by the managers themselves, third party appointments and spontaneous candidacy (investment proposals entrepreneurs submit directly to managers). Table 2.19 provides the aggregate number of proposals received<sup>5</sup> in 2004, as well as details on the investment selection process (proposal analysis, *due diligence*, investment). In all, 3,598 proposals were received and 840 (23%) were analyzed. Only 140 (17% of those analyzed) moved on to the due diligence stage. Finally, 35 out of these 140 became investments (25% of those that underwent due diligence). These 35 investments divide into six deals from spontaneous candidacies, 16 third party appointments and 13 manager prospects. Table III-8 confirms the PE/VC industry's notorious estimate that, out of 100 projects received by managers, only one gets PE/VC injection. These figures show that the selection process is quite strict in Brazil and that considerable funds and resources go into selecting investments in PE/VC assets.

Table III-8 also shows that the means through which proposals come to managers has a bearing on the rate of success. In 2004, spontaneous candidacies (proposals submitted by e-mail, post or telephone) were the main source of investment proposals: 2,297 proposals. But only 353 of these (15%) moved on to the next analysis stage. That same year, 1,301 proposals were received by referral from consultants, investors, banks or people in the managers' business relations, and 310 of them (24%) were thoroughly analyzed.

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<sup>5</sup> PIPE organizations were disregarded because they invest in listed companies for which there is widely available information. In addition these stocks are traded in an environment where investment agreements were quite standardized. As a consequence, business origination and selection variables typical of the PE/VC industry do not apply.

**Table IV-8****Project Selection: Number of Proposals and Approval Rate, by Stage**

Number of proposals (e.g. business plans) received, number of proposals thoroughly analyzed, number of proposals undergoing *due diligence* and number of investments done in 2004 for which information is available on the means of submission. Figures in parentheses are percentages of proposals that moved from one stage to the next. Does not include PIPE deals or managers that did not pursue investments (inactive). Disregards deals that involved cross investment by a manager in another organization with transfer of portfolio firms from the former to the latter. One organization that carried out analyses for another to invest was excluded to prevent double counting.

<b>Stage</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>Means of Submission</b>	<b>Proposals received</b>	<b>Proposals analyzed</b>	<b><i>Due Diligences</i></b>	<b>Investments Made</b>
<b>Spontaneous</b>	2,297	353	29	6
	(15.4)	(8.2)	(20.7)	
<b>Referrals</b>	1,301	310	78	16
	(23.8)	(25.2)	(20.5)	
<b>Prospecting</b>		177	33	13
		(18.6)	(39.4)	
<b>Total</b>	<b>3,598</b>	<b>840</b>	<b>140</b>	<b>35</b>
	(28.3)	(16.7)	(25.0)	

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There is an even clearer difference when measured by the share of projects that make it to due diligence. Out of 353 spontaneous candidacy projects that were analyzed, only 29 (8.2%) moved on to *due diligence*. Out of 310 referrals analyzed, 78 (25.2%) underwent *due diligence*. Also in 2004, 177 investment opportunities were detected by manager prospecting; 33 of these (18.6%) moved on to due diligence.

**IV.2.2 INVESTMENT STRUCTURING**

PE/VC investments typically focus on high-return, high-risk and low-liquidity targets. To navigate such an environment, U.S. PE/VC organizations adopt mechanisms to mitigate potential conflicts. (SAHLMAN, 1990 and GOMPERS, 2001) Some of these mechanism are: 1) shareholders' agreements to align owner interests; 2) the right to appoint auditors in order to assure accounting data reliability; 3) appointment of key executives, such as the CFO and/or CEO; 4) use of financial instruments to enable acquiring control or forcing liquidation should firm performance deteriorate or remain far below projected goals; 5) gradual finance injections contingent upon the fulfillment of previously agreed goals, giving managers the choice of giving up an investment should the firm drift too far from expected performance; 6) clauses to prevent disputes or severe conflicts of interest that may hamper the down-side process; 7) non-competition clause for the firm's main executives,

preventing them from going to work for competitors or establishing a competing firm for a certain period of time. The main purpose of this last clause is to prevent competitors from using strategic information.

For almost 90% of managing organizations, the presence of a shareholder agreement is a requirement for investment. Respondents are so firm about this that 77% agreed in full with the affirmative, and a mere 7% disagreed. (Table IV-9)

PE/VC practitioners in Brazil also feel strongly about preventing competitors from using strategic information: 82% of respondents agreed with the statement “*in order for us to invest, it is essential that the firm’s main executives agree to non-competition clauses*”. More than half (55%) fully agreed with the statement. Only 5% disagreed.

Opposite to what one might expect, acquiring control is not a fundamental point for the most PE/VC practitioners in Brazil. Only 28% of respondents agreed with the statement “*in order for us to invest, it is essential that we have the ability to acquire control*” (only 9% agree in full). Disagreement is far stronger (49%), and 41% fully disagree.

**Table IV-9**

**Investment Structure Conditions (percentage)**

Only the 56 organizations that responded to the statements were considered. PIPEs not included. All figures are percentages.

Statement	Fully disagree	Partially disagree	Neutral	Partially agree	Fully agree
<b>We do not invest ...</b>					
... in the absence of a previous agreement over the basic terms and conditions of the shareholders’ agreement	3.6	3.6	3.6	12.5	76.8
<b>For us to invest, it is essential that..</b>					
... the firm’s main executives agree to non-competing clauses	3.6	1.8	12.5	26.8	55.4
... we have the ability to acquire control	41.1	7.1	23.2	19.6	8.9

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The level of investment vehicles’ ownership of firms in their portfolios enables a more in-depth assessment of the *control* topic. Ownership level was divided into five classes: minority, minority with veto, minority with control, shared control, and majority with full control. For each vehicle, we get the number of structured *deals* in each class. The aggregate provides the universe of *deals* done by the industry (readers are well advised to bear in mind the distinction between **deal** and **invested firm**). It is worth mentioning that

we refer to the number of deals, rather than to the number of distinct firms in the portfolio: where firms received investments from two or more vehicles, their characteristics were considered two or more times for the purposes of this analysis. The results, which can be seen in Table IV-10, verify a curious datum: control acquisition is not the rule in Brazil. Out of the 325 reported deals, only 115 (35.3%) contemplate some sort of control. The most common means of getting control is a majority stake (21.2% of all deals), followed by a minority share with control<sup>6</sup> (used in 9.2% of deals). Shared control appears in only 4.9% of deals. Apparently, absence of control is offset by veto powers, as seen in 125 deals, or 38.5%. Finally, mere minority shares answer for 26% of deals.

**Table IV-10**

**Ownership Level, Portfolio Firms**

Number of deals in the portfolio by ownership level. Includes independent investments and joint investments where the manager operated as leader or non-leader. Therefore, the sum total exceeds the number of distinct firms in the aggregate portfolio. PIPEs not included.

<b>Ownership level</b>	<b>Number of Deals</b>	<b>Percentage</b>
<b>Minority stake</b>	85	26.2
<b>Minority stake with veto powers</b>	125	38.5
<b>Minority stake with control</b>	30	9.2
<b>Equally shared control</b>	16	4.9
<b>Majority stake with full control</b>	69	21.2

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Typical PE/VC vehicles are normally for specified periods of time. Exits must take place before this period has run its course. Therefore, a clear possibility of exit is fundamental for a firm to get a PE/VC injection. More, the investment must be structured in such a manner as to facilitate exiting. Some qualitative questions allow investigating how exits affect investment structuring in Brazil. Table IV-11 reports the results. Not surprisingly, exit-related decisions have great influence on investment structure: for most managing organizations (69.7% of respondents), the absence of prior agreement as to an exit strategy prevents investment (statement “*we do not invest in the absence of prior agreement as to an exit strategy*”). This is reinforced by a generalized sense (78.9% of respondents) that having a clear concept of the exit solution is essential for investment.

<sup>6</sup> Which can be accomplished by using preferred shares and *golden shares*.

Only 21.1% do not see it as an essential condition (statement “*in order for us to invest, it is essential that we have a clear concept of our future exit*”).

**Table IV-11**

**Exit decision (percentage)**

Considers only responses from organizations actively prospecting new investments. All PIPEs excluded. The question only applied to 55 of 65 organizations.

Statement	Fully disagree	Partly disagree	Neutral	Partly agree	Fully agree
<b>We do not invest...</b>					
... in the absence of prior agreement as to an exit strategy	10.7	10.7	8.9	30.4	39.3
<b>In order for us to invest it is essential that...</b>					
... other investors give us drag along rights	7.0	1.8	5.3	40.4	45.6
... we have a clear concept of our future exit	5.3	1.8	14.0	33.3	45.6

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Negotiation of dispute resolution terms may explain the little concern 21.4% of managers show with prior agreement as to an exit strategy. The main difficulty created by the absence of prior agreement concerns a possible lack of investor consensus when it comes to exiting. For example, lack of consensus may prevent exit via trade-sale where acquirer wants to have 100% of the firm’s equity. One way to avoid this issue us to include a drag along clause to force minority shareholders to sell their shares at the same conditions as the controller should the controlling interests take an offer for 100% of the equity. Table 2.31 shows that a drag-along clause is relevant to the overwhelming majority: 86% of respondents deem it essential (statement “*in order for us to invest, it is essential that other investors give us drag along rights*”).

## **IV.3 THE NEW REGULATORY FRAMEWORK OF THE PE/VC INDUSTRY: CORPORATE AND TAX LAWS**

### **IV.3.1 LEGAL ASPECTS**

#### **IV.3.1.1 PRESENT SCENARIO**

From the institutional perspective, there has been a recent and steady development of the Brazilian legal environment for receiving investments from private equity funds.

In 2001, the Brazilian Corporations Law (Law No. 6,404/76, the “BCL”) was amended with the purpose of enhancing and further protecting minority shareholders’ rights, by means of relevant innovations, such as (a) limit for issuance of shares of non-voting preferred stock: new companies may not have more than 50% of their capital stock represented by non-voting preferred shares (previously, the limit was 2/3 of the total capital stock); (b) redemption of shares: the redemption of a certain class of shares now requires the approval of shareholders representing the majority of shares of such class in a Shareholders’ Meeting of the affected class, except if otherwise set forth in the bylaws; (c) Fiscal Committee: its members have increased individual powers to investigate and oversee management on behalf of minority shareholders.

Additionally, there were other innovations to the BCL, which, however, are applicable to listed companies only, such as: (a) delisting of shares: the delisting of a company is conditioned to the launching of a public tender offer to acquire all of the outstanding shares, at a fair price, at least equal to a formal valuation of the company, subject to challenge by minority shareholders; (b) participation in the Board of Directors: the following groups of minority shareholders are entitled to appoint one Board member each: (i) shareholders holding voting shares representing at least 15% of the voting capital and (ii) shareholders holding non-voting shares of preferred stock representing at least 10% of the total capital stock; (c) tag along rights: minority shareholders holding voting shares are entitled to participate in a change of control transaction, receiving 80% of the purchase price per share paid to the controlling shareholder.

However, although the Brazilian private equity industry has grown over the past years, local private equity funds’ activity is still shy as compared to foreign private equity funds.

Because of this, in 2003, the Brazilian Securities Commission (“CVM”) issued Instruction CVM No. 391 to regulate Investment Funds in Private Equity (“FIP”), in an attempt to create an appropriate regulatory framework for the local private equity industry. The FIP is a fund registered with the CVM that must participate in the decision-making

process of the portfolio company and influence its political strategy and its management, especially through the appointment of members of the Board of Directors of such companies or by means of the acquisition of shares of the controlling block or through the execution of Shareholders' Agreements. The close companies in which the FIP invests must adhere to certain Corporate Governance standards, making it easier for the company to adjust to the rules applicable to listed companies in case of a future IPO.

Another step taken to develop the Brazilian capital market was the creation, by the São Paulo Stock Exchange (Bolsa de Valores de São Paulo – BOVESPA) of three corporate governance stock listing levels (Level 1, Level 2, and the “Novo Mercado”) based on a company’s agreement to comply with increasingly stringent corporate governance rules. In order to strengthen enforcement of adoption of such rules by Brazilian listed companies, the National Association of Investment Banks (Associação Nacional de Bancos de Investimentos – ANBID), in its Self-Regulatory Code of Public Offers determines that ANBID’s associates must only participate of public offers with issuers that have adhered, or committed to adhere within 6 months, to at least Level 1 of Corporate Governance. Consequently, all the recent IPOs in Brazil were made by companies adhering to one of the 3 levels of Corporate Governance (including, in particular, “Novo Mercado7”, which sets forth the most stringent corporate governance rules).

Compliance with the above mentioned listing levels requires, among other items, (i) better disclosure of information and financial statements, in some cases with observance to the US GAAP and IAS, (ii) maintenance of a minimum flow of 25% of outstanding shares, (iii) adoption of special proceedings for public offers, (iv) independent members and unified term for the Board of Directors, (v) voting rights to non-voting preferred shares in certain resolutions, and, in the Novo Mercado, prohibition of issuance of non-voting shares or shares with restricted voting rights, and (vi) tag along rights to minority shareholders in change of control at 100% of the price per share paid to the controlling shareholder.

The requirements of Novo Mercado and Level 2 also include the need for the bylaws of listed companies to provide for arbitration pursuant to BOVESPA rules in connection with any dispute involving shareholders and the company. This requirement comes in the footsteps of another recent innovation to the BCL that admits arbitration as a dispute resolution mechanism pursuant to the bylaws of the company, introduced as an attempt to provide broader and faster enforceability to shareholders’ rights.

As of today, there are 20 companies listed in the Novo Mercado, 11 in Level 2 and 36 in Level 1. The market price of companies listed in one of the BOVESPA’s corporate governance levels has increased overtime due to, in accordance with market analysis, the new listing requirements. At this point, one can state that the Brazilian capital market has

gained strength since 2001, with the increasing participation of foreign investors. According to BOVESPA, foreign investors had the highest trading activity in BOVESPA (around 32.15%) in October 2005.

In addition to the innovations in the legal and regulatory framework as indicated above, private equity investors typically demand that shareholders execute a Shareholders Agreement contemplating additional rights. Such agreement is an important tool for minority shareholders to obtain rights that are not otherwise afforded by the BCL and regulations, although there are some cases where investors have been disappointed because of enforceability difficulties before Brazilian courts.

It is worth mentioning that the BCL now allows the chairman of the shareholders' meeting or of the meeting of the administrative body (specially the board of directors) not to consider a vote in violation to a Shareholders' Agreement. In addition, if a shareholder (or its representative at the management) is bound to a Shareholders' Agreement and does not attend to the shareholder meeting to exercise its vote (or does not exercise its voting rights) pursuant to the agreement, then the other shareholders parties to the Shareholders' Agreement are entitled to vote on behalf of the party in breach.

In order to avoid court proceedings (which are typically time consuming and frustrating to minority investors due to a lack of precedent), parties to a Shareholders Agreement have more and more chosen to resolve disputes through arbitration, whose awards Brazilian law now recognizes as enforceable.

#### **IV.3.2 TAXATION OF PRIVATE EQUITY AND VENTURE CAPITAL INVESTMENTS IN BRAZIL**

We have seen in the previous section that in the legal field Brazil has reached significant development in recent years with the amendment to the BCL.

As to investments in Private Equity and Venture Capital, whereas specific investment vehicles have already been regulated by CVM, the Brazilian tax law has so far failed to provide differentiated treatment that reflects the particular needs of this kind of investment.

Investments via private equity funds, such as FIP and FITVM, (Investment Funds in Listed Companies), enable the deferral of taxation on capital gains. However, those types of funds, which are dealt with by a specific section of the law, are subject to a withholding tax of 20% upon redemption or sale of quotas, higher than the 15% rate levied on variable income funds (whose assets are at least 67% of shares traded in stock exchange).



That difference remains when it comes to non-resident investors qualified under the terms of the Resolution No. 2.689 from the National Monetary Council – CMN. For these investors, the income tax rate for FIP and FITVM is reduced to 15%, whereas the rate for variable income funds goes down to 10%. See the chart below:

Operation/Event	Tax rate
Capital gains (gains from operations carried out in stock exchange, futures and commodities exchange and <u>similar</u> , except fixed income-type operations)	Exempt
Variable income funds, swap operations and operations carried out in future settlement markets out of stock exchange	10%
Fixed income gains and other types of income (including those derived from equity investment funds, such as FIP and FITVM)	15%

Until February 15, 2006, the tax rates applicable to variable income stock managed funds (15% for residents and 10% for qualified non-residents) had not been extended to FIP and FITMV.<sup>7</sup> It seems that the Brazilian legislator have traditionally had a certain preference for encouraging stock exchange investments (via variable income funds or directly — where tax exemption applies) and have not yet recognized equivalent tax rates for capital gains of private investment funds in non-listed companies or the OTC market.

Despite the absence of a specific tax treatment for Private Equity and Venture Capital at the de-investment phase, we must recognize some alternatives established by Brazilian tax law that facilitate investments, such as the ‘Juros sobre Capital Próprio’ (interest on capital stock) – a tool for remunerating shareholders with a deductible payment, and the system for assessing the income tax due by the invested company on the basis of a assumed profit margin.

Furthermore, the Brazilian Government has enacted the Provisional Measure No. 252, known as “*MP do Bem*” (Provisional Measure of Good), which Congress converted into Law No. 11.196/2005. This new law offers a series of benefits to those activities that promote technological innovation, investments in micro- and small-size companies, among others.

Law No. 11.196 is a decisive contribution to new investments in technology as it alleviates a good part of the most severe difficulties investors face, e.g. the taxation on the

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<sup>7</sup> A recent Provisional Measure MP281 has just been enacted on Feb 15, 2006. It extends exemption of capital gain taxes to foreign investments in high-tech VC funds (FIP and FITMV). It also aligns the tax rate on capital gains on Venture Capital and Private Equity funds with the rate applicable to other stock managed funds, a 15% tax rate for all resident investors.

import of capital goods (machinery, equipment, etc.), of technical services and of intangibles (especially from related entities), among others. In sum, the most important benefits found in the new law include:

- \* Deduction of technological research expenses;
- \* 50% reduction of IPI (Excise tax) levied on machines, equipment and instruments intended for technological research and development;
- \* Accelerated depreciation of certain goods used in technology research and development activities;
- \* Accelerated amortization of intangible assets connected with technology research and development activities;
- \* Credit for the withholding tax on amounts remitted to foreign countries for royalties, scientific and technical support, and specialized services, included in technology transfer agreements;
- \* Reduction to 0% of the income tax rate on remittance of amounts intended for filing and maintaining trademarks and patents.

Besides that, Law No. 11.196 expanded the SIMPLES, an integrated tax payment system for micro- and small-size companies that allows companies that meet some requirements to pay a single tax, calculated at a variable tax rate (3% to 12.6%) according to its monthly income, replacing the following taxes and contributions: IRPJ, CSLL, COFINS, PIS, IPI and the Employer's Social Security Contribution (INSS).

Despite future changes to further protect and enhance private equity investments that we believe should be carried out to turn Brazil into a leading destination for private equity investments, it is undisputable that the recent amendments both in the tax and in the legal fields have enabled building an attractive and fully operating market for Private Equity and Venture Capital investments.

## **V. GOVERNMENT SPONSORED PROGRAMS TO INCREASE VENTURE CAPITAL FINANCING OF SMES: SOME LESSONS FROM INTERNATIONAL EXPERIENCE**

Since the 1980s, a wave of technological revolution spreads all over the world. As consequence, countries must qualify themselves strategically for competing with other countries in creating and trading products with high value-added ratios in order to be inserted in this globalization scenario and prevent the loss of industrial plants to more competitive economies.

According to Porter (1990), only a positioning favorable to innovation gives country competitive advantage and, consequently, sustains long-term growth. In view of this, many emerging countries are repositioning themselves by investing significant proportion of GDP in human capital qualification, and the establishment of technological laboratories and industrial facilities.

A key success-factor in this scenario is the financing of innovative enterprises. According to Black and Gilson (1998), companies with fast-paced growth, high risk and intangible assets, require “own” capital for financing product development or growth, instead of debt, which would involve guarantees.

The venture capital industry has been notorious for its ability to extend funds to innovative fast growing firms. In particular, there is abundant evidence that venture capital has promoted innovation in the US: Kortum and Lerner (1998) find empirical support by examining the influence of Venture Capital funds on the invention patents of 20 sectors in the United States during three decades. In view of this, governments worldwide are supporting the development of their venture capital industry, by adjusting the US model to local characteristics and also by changing the local institutional environment (Lerner and Schoan, 2004).

However, the positive effect Venture Capital has on innovation does not occur regularly and homogeneously across all high technology areas. According to Lerner (apud GINSBERG, 2002), one of the reasons is the cyclical nature of the Venture Capital industry, caused by the constant tension between supply and demand. Supply is determined by the investors’ desire to invest in Venture Capital funds seeking high returns. On the other side, the demand is determined by the number of entrepreneurial companies in search of funding. Both sides are affected by time and information. The tension arises when there is a gap between the return investors expect and the number of enterprises that meet this expectation.

During the cycle’s peak, funds finance their project less effectively. One of the problems that arise at this time is the duplication and concentration of projects in certain

industries. Lerner (apud GINSBERG, 2002) mentioned an example in the United States. During the period from 1998 to 2000, Venture Capital concentrated its investments in two areas, Internet and telecommunications, which have absorbed 56% all Venture Capital investment in 1999. At the same period, other promising areas, such as advanced materials, energy technologies, micro-electronics, failed to capture the attention of fund managers. Therefore, Venture Capital encourages innovation in an irregular and heterogeneous way across innovation sectors.

The government can increase the offer of funds by creating mixed Venture Capital funds with the participation of the public and private sectors. In other words, the government might be an investor, or quotaholder, within a Venture Capital fund, or Venture Capital fund-of-funds. Such funds-of-funds will ensure availability of a portion of the capital stock for companies that are affected by the weak phase of the Venture Capital market.

Government participation is also important for directing investment to strategic sectors that do not provide such attractive returns for the Venture Capital. According to a report by Almeida Capital Research (2005), there are research projects that demand significantly high investments for their realization and do not offer commercial attractiveness at their initial stage. In a first moment, the government may create a fund basically with public funds for investing in these projects. In the long run this fund would tend to attract more Venture Capital from the private sector.

## **V.1 A BRIEF OVERVIEW OF RELEVANT INTERNATIONAL EXPERIENCES**

### **V.1.1 THE NORTH AMERICAN EXPERIENCE**

Professor Gilson (2003) argues that Venture Capital investors in the USA enjoy a control position greater than their share of stock alone justifies. They have veto right in terms of the main decisions, hold the continuity decision, and frequently control most of the Board, in addition to having the right of terminating the enterprise.

With control and interest, Venture Capital fund managers have at their disposal mechanisms and incentives for monitoring highly encouraged entrepreneurs. A carried interest of 20%, based on 1% of capital contribution, enables them to achieve huge returns. With this incentive, fund managers not only provide capital to invested companies, but also non-monetary resources, such as knowledge and contacts for converting the products of research into saleable products. The failure in one of the companies in the portfolio would affect the Venture Capital investor's ability to capture new subsequent funds, and therefore, the value of their human capital, thus ensuring that they also share the risk of losses.

In the American model, the government provides funds to selected Venture Capital funds managed by qualified professionals, without participating in the capital allocation process. This model also includes the structure of these funds and the contract structure of the company in the fund's portfolio.

### **V.1.2 THE GERMAN PROGRAM - WFG**

Established in 1975, the German program serves as an example of the limitations of governmental engineering and reveals fundamental differences in the structure of incentives, when compared to the American experience.

**Table V-1**  
**Factors that may affect the Venture Capital market**

	<b>Germany – WFG</b>	<b>USA</b>
Governmental guarantee for the banks	Generous guarantee for the banks * The government guaranteed up to 75% of the WFG losses: low risk	There was not a guarantee
Control	WFG Board: 12 members * 3 from banks * 3 from government * 2 from consulting firms * 2 industry representatives * 2 scientists	Venture Capital investors often control most of the board; they have veto right on decisions such as continuity or termination, etc.
Participation of the government as investor	Passive investment of WFG, but participates in capital allocation, because members of the government participate in the Board	Government participation as passive investor in the fund enables the government to provide funds to the new market, but without participating in the capital allocation process.
Control rights	None	Control position higher than its share of equity
Replacement of the founder entrepreneurs	WFG did not make replacements	More than half of the founders have been replaced in the Silicon Valley
Technical and managerial assistance for companies in the portfolio	WFG employees did not provide non-financial support	Fund managers provide services, know-how and contacts
Selection of projects	Based on the performance of the company in the portfolio	
Technical and managerial assistance for companies in the portfolio	WFG employees did not provide non-financial support	The fund administrators provide services, know-how and contacts for converting the products of research into saleable products
Incentives for performance	No member in the Board was either rewarded or penalized by the performance of WFG	Carried interest of 20%, based on 1% of capital contribution * possibility of high returns
Monitoring mechanisms	None	Appropriate as a contracting model
Job market regulation	Severe restrictions for dismissals, implying in higher initial costs and discouraging businesses	Flexible job market
Cultural aspects	Less entrepreneurial, less willing to assume risk of failure	More entrepreneurial, more aimed at risky businesses
Development of the stock market	Weak (strong role played by banks)	Strong
Do pension funds invest in Venture Capital?	No	Yes, significantly
Venture Capital market	Less active	More active

Source: prepared by the author, based on Gilson (2003) and Black & Gilson (1998).

### V.1.3 THE ISRAELI PROGRAM – YOZMA AND INBAL

The Israeli program Yozma, founded in 1993, is one of the most successful ones, and is documented in the case studies of the Harvard Business School (ZUCKERMAN; FELDSTEIN, 2003). According to Gilson (2003), the Yozma participation structure in these funds was very different from the government and bank participation in the WFG: a) Governmental guarantees to banks were nonexistent; b) Yozma provided capital to funds, up to 40% of the capital invested by the private investors. These investors shared loss risk with fund administrators; c) Yozma structure maintained strong performance incentives for returns. There was no upper limit on return on investment (Table V-2); d) Like the American Model, Yozma did not have decision-making power on investments.

**Table V-2**  
**Differences in the upper investment limit Yozma vs. WFG**

	<b>Yozma</b>	<b>WFG</b>
Investment	Venture Capital fund	Directly into the portfolio's company
Purchase option	Maintained by other investors	Maintained only by the entrepreneur
Incentives and Monitoring	<ul style="list-style-type: none"> <li>* No upper limit to returns to intermediate financial agents</li> <li>* The purchase option leveraged returns, and therefore, the incentives for intermediate financial agents</li> <li>* Subsidy for other investors increased the incentive for ensuring that the companies in the portfolio were well monitored</li> </ul>	Subsidies to banks and entrepreneurs eliminated incentives for WFG or participating banks to monitor the entrepreneur's behavior.

Source: prepared by the author

Despite stock market issues (domestic IPO) and regulations, Israel overcame these barriers by making strategic alliances with American Venture Capitals. The Israeli government supplemented the Yozma program with two additional parallel programs: Inbal (encouraging investments in Venture Capital funds by the stock market) and incubator program (employing the flow of immigrant scientists and helping underdeveloped regions of the country).

### V.1.4 THE BRITISH PROGRAM

Great Britain has an experience in using the Venture Capital mechanism for encouraging investment in the high technology sector. According to Almeida Capital

Research (2005), 26% of all active Venture Capital funds were fully or partially, supported by public funds in 2005. Among these funds, 32% are governmental only, with partial government involvement in the remainder. In the past 3 years, public funds have been responsible for more than half the new funds formed. One of the reasons for such amount of investments was the dot-com crisis in 2001.

The same research points out financial goals as the main difference between two major types of funds. While the government’s goal is to develop the high technology industry, encouraging economic development and job creation, the private sector’s aim is to secure financial gains for shareholders. Profitability is a matter of survival in the private sector.

Another difference found in the British Venture Capital market is that the private Venture Capital investment volume is higher by invested company. Funds prioritize companies that have already left the initial phase and are in the growth and maturation phase (Table V-3). Finally, private Venture Capital tends to invest in companies near large urban centers (e.g. London), while public funds focus on several regional funds.

**Table V-3**  
**Number of investments per stage in 2003-2004**  
**(Private and public funds)**

Development stages	Private funds	Public funds
Seed	150	145
Start of activities	517	175
Growth	475	189
Others	14	49

Source: Almeida Capital Research

Thus, the participation of public funds fills in the financial “gap” left by private Venture Capital funds. The three major public funds are: Regional Venture Capital Funds (RVCFs), Early Growth Funds (EGFs) and University Challenge Seed Funds (UCSFs). These funds are managed by independent administrators and focus on segments private funds disdain. They also play an important role in allocating investments for research centers located outside metropolises, reducing the capital access issues endured by more distant regions.

With the concentration of private funds in the innovations sectors, the government optimizes the allocation of its funds for developing the sectors, according to the country’s long-term competitive strategy.



In order to develop the industrial sector, the government may increase the offer of funds by establishing mixed Venture Capital funds or Venture Capital fund-of-funds, with the private and public sectors' participation. Israel (Yozma fund) has followed the United States model in the early 1990s and succeeded. Germany has developed a structure that differs from the American model in all major aspects. The German model failed by not properly addressing the issue of incentives to intermediate financial agents, which should be responsible for monitoring and supporting entrepreneurs. The WFG was protected against the risk of losses by governmental guarantees and prevented from achieving and high gains due to limitations caused by a moderate interest rate – low risk (due to the guarantee) and low investment return (due to the purchase option).

By comparing these experiences, we conclude that the success of the joint government and private sector funds requires proper governmental handling of the incentives' problem across the three Venture Capital elements: investor, entrepreneur and financial intermediary (manager). The government should provide the capital to VC funds – specialized in bridging the gap in the initial phases of company growth – and play an active role in the selection of a professional manager with the implementation of a strong governance mechanism (American contracting model) conceived to monitor and encourage administrators and entrepreneurs. At the same time, the government should have a passive position in connection with investment selection.

The Israeli experience illustrates an important example of using strategic alliances with American partners and how to overcome some local restrictions. Listing these companies in the NASDAQ has solved the lack of liquidity problem for technology-based company stocks. The intense interaction between American entrepreneurs and fund administrators has also provided learning for qualifying the Israeli fund managers.

In spite of the importance of the Venture Capital market, it is neither enough for, nor does it promote, homogeneous innovation in all high technology areas. The NASDAQ crisis in 2001 illustrates how a financial crisis may impair the Venture Capital industry offering in Israel. The British experience also illustrates the entrance of public funds in the Venture Capital market, reaching marginalized segments and geographic areas.

Another reason lies in Venture Capital investors' tendency to specialize. The Israeli Venture Capital market's decision to specialize by focusing on specific sectors and stages favored and attracted the interest of the American Venture Capital for the Israeli entrepreneurs' project. The funds created by the English government have also encouraged the more generalist sectors and other specialized sectors.

Therefore, in order to achieve an advantageous a sustained position in the future, the government must reduce the specialization effect and the cyclical effect of the Venture

Capital market, investing in public VC funds that support companies in the seed and initial phases of activities. Also, the government should provide on-going financing to strategic projects that may not have medium-term appeal to the Venture Capital market.

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