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Venture Capital Companies

IFC has invested nearly \$40 million in venture capital companies (VCCs) in developing countries in Africa, Asia, Europe, and Latin America. The performance of these VCCs has been mixed. Many of the earlier VCCs performed poorly but recent ones appear more promising. In a recent review, IFC's independent Operations Evaluation Unit (OEG) examined eight venture capital companies launched during 1976-86 and analyzed the reasons for their success or failure. The factors examined were the investment environment, capital market conditions, the problems inherent in introducing the concept of venture capital financing to new markets, and the way the VCCs were structured and managed.

Investment Environment

Although most countries would benefit from increased reliance on equity capital, not all countries offer a business environment conducive to successful venture capital operations. Several of the VCCs reviewed found few openings for the right investments. Small, slowly growing, inwardly oriented economies with a limited, relatively unsophisticated entrepreneurial base are unlikely to provide much scope for the development of enterprises that provide the high returns VCCs must seek. Although turnaround situations may offer some opportunities, expecting a flow of attractive investments large enough to justify a VCC may not be realistic in these countries.

Capital Market Conditions

Countries that do not have active stock markets that value stocks at good price/earnings multiples and that do not facilitate initial public offerings do not provide the opportunity to realize the high returns a VCC needs on its successful investments. Where stock markets were buoyant and requirements for initial public offerings on the local second-tier market were liberal, substantial capital gains were possible. Where stock markets were inactive (annual trading of \$3 billion or lower), stock prices low (prices below 10 times earnings per share), and initial public offerings hindered by excessive regulatory constraints, the potential for realizing substantial capital gains was restricted. This problem may be overcome in some cases to the extent that cross-border stock listings are becoming possible, but it is likely to remain in many parts of the world.

Introducing the Venture Capital Concept

Most of the VCCs reviewed were the first in their markets and had to introduce the concept of venture capital financing. Doing so took time; meanwhile, the VCCs had to face major problems in attracting resources and in attracting the right clients.

Attracting resources

New VCCs often find it difficult to raise resources. Investors in many countries are not accustomed to investing in a fund that others will manage, particularly when the money will be invested in small, risky enterprises. The venture capital business in the United States took off after one early VCC was spectacularly successful and investors became excited about the potential returns on venture capital investments, thus making it easier to raise new funds. In other countries, where the venture capital concept was new, where there was no established track record, and where investors considered it important to retain control of their funds, raising money

was a challenge. To mobilize funds in these countries, many VCCs have had to make major concessions such as allowing investors to participate in investment and divestment decisions.

Even after the initial funds were raised, problems remained. The initial funds were aimed at covering the VCCs' requirements for two to five years. To continue making new investments once these resources were committed, the VCCs had to raise additional capital. Yet they could not have developed a track record in such a short period, particularly if they invested in early-stage ventures. Although four VCCs were able to raise additional capital because of encouraging early results, four others could not do so and dropped out of the venture capital business.

Attracting the Right Clients

Inviting the participation of outside equity investors is not customary in most developing countries. Entrepreneurs are generally unaccustomed to exposing their project ideas, providing extensive financial and operational information, sharing profits, and allowing some degree of external control of their ventures. They are not aware that an experienced venture capitalist may be able to help them expand and boost the profitability of their companies. Even when they recognize the potential benefits, they may still decide against opening their companies, to retain full control rather than maximize their net worth. Or, when they do allow outside investors to participate, they still may not be willing to treat them fairly. Until venture capital financing is widely accepted in a country, a VCC may not have access to a good selection of investment opportunities.

Structuring VCCs

The way VCCs are structured can have a major impact on their results. Two issues are involved: the separation of ownership and management, and the splitting of profits.

Separation of Ownership and Management

Venture capital operations can be based on a one- or two-tier structure. In a single-tier VCC, the investors provide the resources and make investment and divestment decisions through the board of directors or a committee representing the shareholders and management. In a two-tier structure, the investors provide the resources to a venture capital fund, and a separate venture capital management company makes these decisions. Based on problems arising in one or two of its earlier investments, IFC concluded that two-tier structures were preferable. OEG found that this conclusion was generally correct but that how these issues were handled was more important than the form.

Control of investment and divestment decisions. One early single-tier VCC was unsuccessful because (contrary to its exposure guidelines) its shareholders, who controlled the board of directors, pushed it into investing nearly half its resources in a single enterprise that performed poorly. This risk, however, cannot be avoided simply by using a two-tier structure. Until investors develop confidence in the ability of a venture capital management company to realize high returns, they are likely to insist on some involvement in decision-making. Since missed opportunities may be less costly than excessive concentration or bad investments, the most practical solution may be for management and some representative(s) of the investors each to have veto power over investments. In fact, two successful VCCs have dealt with the issue this way.

Raising additional resources. With a single-tier structure, existing shareholders, whose financial interests would be directly affected, must agree on a subscription price for new investors. Under a two-tier structure, a venture capital management company can simply raise resources for a new fund without having to seek agreement on the valuation of investments held by earlier funds. Again, however, this consideration does not completely exclude single-tier funds. Indeed, two VCCs that started out on a single-tier basis were successful in raising additional resources. One adopted a two-tier structure once its initial resources were invested. The other added a second-tier fund, undertook to make and manage equity investments on behalf of certain offshore investors, and had a successful rights offering at par to continue its own single-tier VCC operations.

Ability to liquidate investments. A two-tier structure usually calls for divestment of the VCC's portfolio by a certain time and thus makes it easier for investors to recover their investments and realize profits. A venture capital management company may be more likely than a single-tier VCC to respect this sort of commitment because it sees itself as managing a series of funds and recognizes the need to respect its commitments if it is to continue raising additional resources. Thus, starting with a two-tier structure makes it simpler for investors to liquidate their investments.

Splitting of Profits

In the two-tier structures reviewed, the venture capital funds had to give a larger share of the profits than is normal in North America to the management companies. The less favorable terms may have reflected the need for more lucrative contracts to attract foreign venture capital management companies (particularly because of the lesser expectations of large profit-based fees), the need in some cases to allow lead investors to share in the profit-based fees, and inexperience. OEG's review identified some provisions that might be improved.

The incentive fees in all the contracts reviewed allow the management company to take a 20 percent share (after the investors have recovered their capital) not only in capital gains but also in dividends, interest income on short-term deposits or loans, and fee income. Contracts in North America usually provide for revenues other than capital gains to accrue entirely to the investors. Allocating 20 percent of these revenues to the management company can be costly to the investors and creates incentives that run contrary to the investors' interests.

Two of the contracts reviewed called for adjusting the management fees for inflation, but only one called for similar adjustments to the capital to be recovered by the investors before incentive fees are payable. Both types of adjustments are appropriate (although these adjustments will be less important when the capital is dollar-based and dollar inflation is low). See box.

Management

Finding appropriate managers for VCCs in developed countries where venture capital operations are well-established is difficult. Finding them in developing countries is even more so. As a result, all the VCCs surveyed had to start with inexperienced local management teams. One of the major sources of venture capitalists in developed countries—successful entrepreneurs who have sold their firms—is generally not available in developing countries. Even when a VCC has had the help of an outside technical partner, its managers have needed time to learn the trade and to convince others that it is able to operate effectively. Without a track record of success, a venture capitalist may find it difficult to convince potential clients of his ability to add value to their enterprises. A good venture capitalist will learn over time, but the results may not be fully reflected in the results of the initial venture capital fund.

A lack of experienced venture capitalists was not the only management problem facing the VCCs. In many cases, the VCCs were not able to attract staff with good potential or to provide them with the right incentives. Investors in VCCs normally seek high returns from capital gains on rapidly growing companies. To attract the type of managers and staff needed to achieve this goal and ensure that the incentives are consistent with the investors' interests, a VCC must provide bonuses, usually in the form of a meaningful participation in realized capital gains.

The success or failure of the VCCs reviewed reflected management's handling of three key issues: its approach to investment decisions, its structuring of the deals entered into, and its supervision of the VCC's investments.

Investment Decisions

The successful VCCs devoted great importance to assessing the management of potential clients. Their efforts may have been facilitated by operating in a relatively compact region or by easy access to their own investors, who often knew the would-be clients. But they were also willing to spend time checking with large numbers of former employers, employees, or others. In

contrast, some of the less successful VCCs gave inadequate attention to management assessments.

Structuring Deals

How the VCCs structured their deals also played an important role in performance. Although the VCCs were set up to make equity investments or investments with equity features, two of the companies also provided loan financing without receiving options or conversion rights to acquire additional shares. The contractually limited returns on these loans depressed the overall returns on their portfolios.

The price paid to acquire shares in a company has a significant impact on the returns. Entry prices are partly a matter of timing, reflecting to some extent the general level of stock prices in a country. But they are also a matter of discipline on the part of the VCC. The technical partners in two of the VCCs emphasized the importance of being willing to walk away from a proposed investment if a satisfactory price could not be negotiated.

Where prospects for initial public offerings are uncertain, VCCs must negotiate from the outset alternative exit arrangements, for example, by structuring their investments in the form of convertible loans, redeemable participating preference shares, or straight equity investments backed by put options. One of the successful VCCs was particularly effective in using such instruments in an environment where prospects for initial public offerings were poor.

Assume that a two-tier venture capital fund invests 1 million pesos at the outset, that inflation averages 7 percent per annum for ten years, and that the fund divests its holdings for 2 million pesos at the end of the ten-year period, i.e., at cost in real terms. With a typical 80:20 split, the investors will receive 1.8 million pesos (their original contribution of 1 million pesos + 80 percent of the 1 million pesos of "profit"), and the management company will receive 0.2 million pesos. In real terms, however, the investors will have received only 0.9 million pesos, i.e., 0.1 million pesos less than invested in real terms, but the management company will still have received a profit-based incentive fee.

Monitoring and Supervision

The successful VCCs had effective monitoring and supervision systems. They normally took one or more board seats, spoke frequently with management, and advised on strategic, financial, market, staffing, and other issues. VCCs that were able to assist their portfolio companies effectively generally had staff with experience in managing ventures similar to those held, assigned a small number of companies to each experienced staff member, and generally operated within a geographically compact area.

VCCs need to concentrate their efforts on investments offering the best prospects for substantial gains and, when problems arise, they must exert their influence to effect necessary changes. One of the unsuccessful VCCs devoted 80 percent of its management's time over an extended period to one venture in which it had a significant stake but limited possibilities for gain. The VCC, moreover, was reluctant to insist on essential changes in management and corporate strategy, and the venture was never able to overcome its problems.