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BRAZIL CONFIDENTIAL

FINANCE

Private equity: a second wave of tech interest

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Our survey of funds highlights increased competition in the sector, but more targets are available, as accelerators take hold.

Executive summary

- The arrival of venture capitalists from the US and Europe during 2010 and 2011 has increased competition in the technology start-up sector in Brazil. 14 of the 24 investors interviewed in a Brazil Confidential survey said competition to invest had become more intense over the last six months.
- The emergence of seed capital funds, angel investors and so-called digital accelerators, which provide start-ups with intensive mentoring programmes and resources aimed at 'accelerating' their growth, is improving the quality of start-ups. 11 of the funds we interviewed said it was easier to find companies in which to invest.
- Valuations remain high and it continues to be difficult to exit investments, but our survey suggests conditions are not uniformly tough. Five respondents said valuations had fallen over the past six months and three said that exiting an investment had become easier.
- Although some of the original wave of Silicon Valley investors have withdrawn, there have also been new entrants from both the US and Europe. The B2B market, where valuations are lower than in consumer-focused start-ups, is one opportunity. International players could also help fill the funding gap in the growth capital segment, compensating for a deficiency of local players in this area.

Two years ago US and European venture capitalists specialising in the technology sector started to examine investment opportunities in Brazil. After more than a decade of growth in China and India, investors were drawn in by the potential to develop social media, online gaming and e-commerce businesses in Latin America's largest economy (BC Apr 14 2011, Private equity).

Over the last year this development has continued. Competition has picked up and deals have become more expensive. Funds have started to co-operate and co-investment is more common. According to a November report by Telefónica Digital and research group Startup Genome, São Paulo is now a more attractive location for new technology investments than any other city in the emerging markets, outranking rivals such as Moscow, Bangalore, Singapore and Santiago.

How São Paulo ranks

Global Startup Ecosystem Index, November 2012

City	Overall ranking
Silicon Valley	1
Tel Aviv	2
Los Angeles	3
Seattle	4
New York City	5
Boston	6
London	7
Toronto	8
Vancouver	9
Chicago	10
Paris	11
Sydney	12
São Paulo	13
Moscow	14
Berlin	15
Waterloo (Ontario)	16
Singapore	17
Melbourne	18
Bangalore	19
Santiago	20

Source: Telefónica Digital and Startup Genome

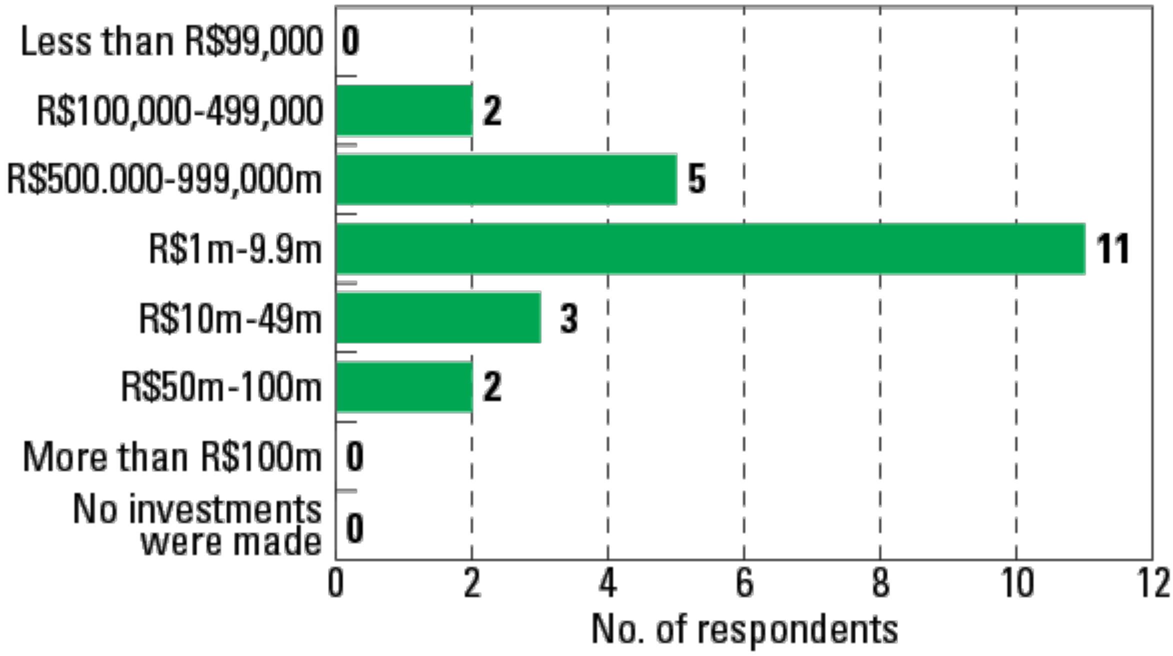
São Paulo's ranking by criterion

Start-up output	9th
Funding	10th
Performance	15th
Talent	19th
Support	11th
Mindset	5th
Trendsetter	16th
Differentiation from Silicon Valley	4th

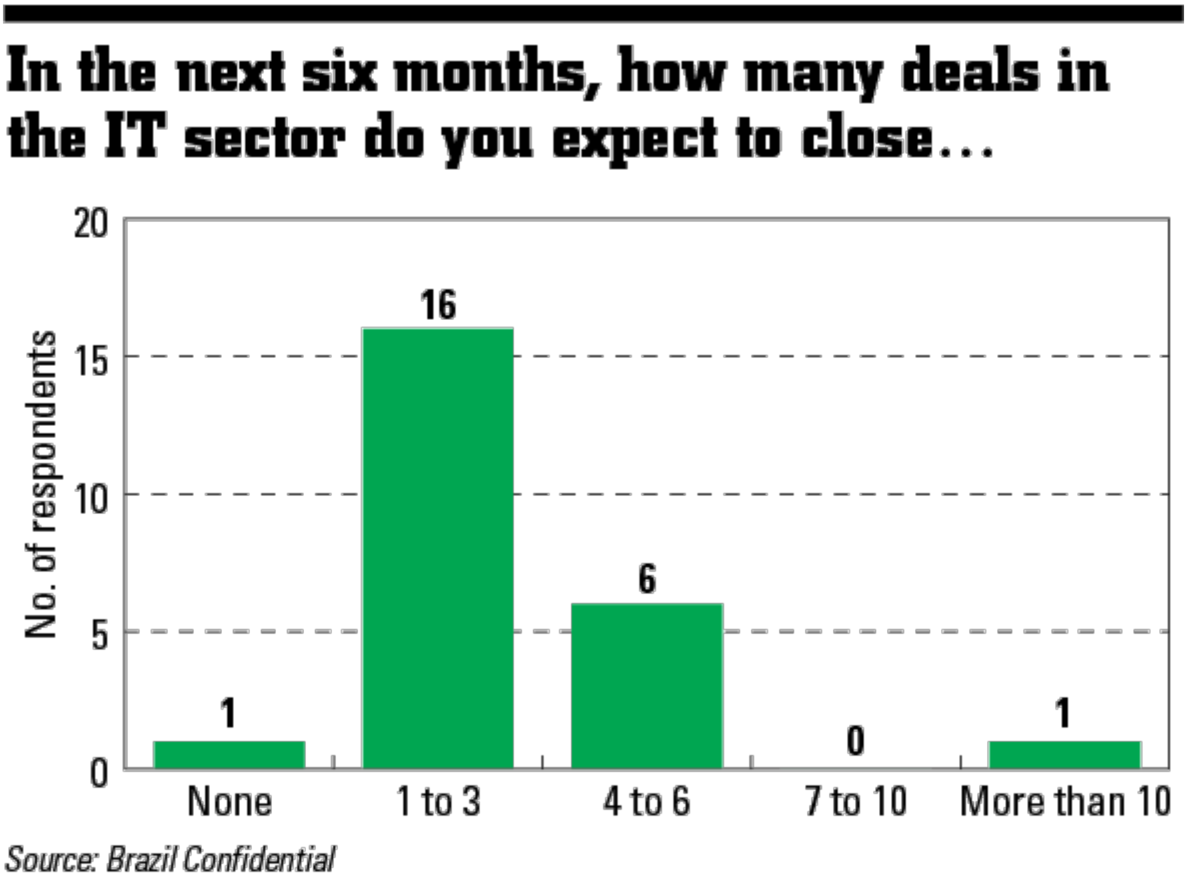
Source: Telefónica Digital and Startup Genome

During the last week of November, Brazil Confidential surveyed 24 local and international venture capital funds, digital accelerators and angel investors in order to investigate these trends further. Most had invested over R$1m in the past six months, and expected to close at least one deal within the next six months.

In the past six months, how much has your company invested in the IT sector?



Source: Brazil Confidential



Attack of the clones

Start-ups in consumer internet, mobile, media and cloud technology have attracted the most interest from international funds. A recent example is the launch of a $130m Brazil-focused venture capital fund by Silicon Valley's Redpoint Ventures and e.ventures (formerly BV Capital) in July. Last month the fund made a follow-on investment in the São Paulo-based start-up 55 Social, which provides monitoring and marketing tools for social media. Other companies in their portfolio include travel website ViajaNet, internet platform Grupo Xangô and e-commerce business Shoes4you.

International venture capitalists have tended to invest in so-called "copycats" in emerging markets, or start-ups that mimic successful businesses already proven in developed markets. Such investments are seen as less risky. So-called "cloning factories" specialising in this kind of operation have emerged and are now making their way to Brazil. A pioneer in the segment is Berlin-based Rocket Internet, which was formed in 2007 and has since launched over 100 clone companies worldwide. In recent years Rocket has founded 11 start-ups in Brazil including Dafiti, a Brazilian version of Amazon's (AMZN:Nasdaq) online shoe store Zappos. Rocket invested in Dafiti in January last year and has helped it become one of Brazil's largest online retailers, with 60,000 products, 550 brands and revenue of R$400m ($189m) in 2011. In August, Dafiti received R$90m in financing from JP Morgan (JPM:NYSE).

Rocket Internet is also working with Groupon (GRPN:Nasdaq), which faces competition in Brazil from the local copycat start-up Peixê Urbano. Team Europe, another German incubator, is also eying opportunities in Brazil. Finally, São Paulo private sales site Brandsclub has hired a third German clone factory, Springstar, to develop its businesses outside the country.

Tropicalisation

Another common strategy in the "copycat" market is so-called 'tropicalisation', whereby investors tweak business models developed elsewhere by adding local features. One example is the Brazilian online store for baby and maternity products Baby.com.br. Baby is the Brazilian answer to the US-based e-commerce company Diapers.com, which was bought by Amazon in 2010 for $545m. In June, Silicon Valley's Accel Partners and Tiger Global led a $16.7m Series B financing round for Baby, its second financing round after receiving $4.5m last year from São Paulo-based Monashees Capital and US funds Tiger, Thrive

Capital, SV Angel and Felicis Ventures, among others.

American entrepreneurs Kimball Thomas and Davis Smith founded Baby in 2010 and have sought to give it a local flavour by hiring popular Brazilian celebrity Angélica (a TV presenter, singer and also a young mum) to recommend new product lines and act as a brand ambassador. In July, Baby's founders launched a spinoff flash sales site for children's products known as Dinda (in Portuguese, "godmother"), tapping into the importance attached to godmothers in Brazil.

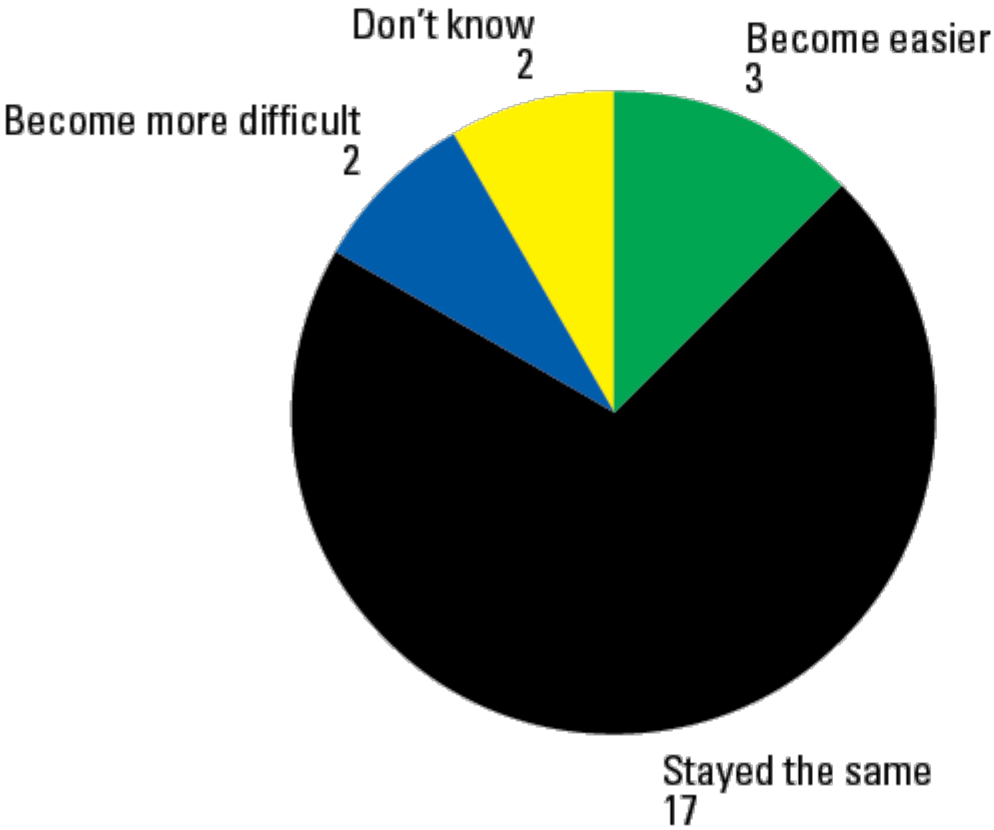
Yet while businesses like Baby are taking off, such opportunities are not easy to come by. Brazil's pool of entrepreneurial talent is much smaller than that of the US or Europe, and those involved in start-ups tend to lack experience. According to data from Telefónica Digital and Startup Genome, there are 80% more start-ups in Silicon Valley than in São Paulo. Moreover, entrepreneurs in São Paulo are 60% less likely than their Silicon Valley equivalents to be involved in a series of ventures. In our survey ten of the 24 respondents said that finding opportunities was their biggest investment challenge in Brazil.

Exits still tough

A further challenge is divesting. The co-founder of Redpoint e.ventures, Anderson Thees, told Brazil Confidential that exiting investments is "the biggest uncertainty" in the local market. Only three of our respondents believed it had become easier to exit investments over the past six months.

In the past six months, exiting investments has...

No. of respondents



Source: Brazil Confidential

One reason for the sluggish pace of exits is that technology start-ups in Brazil are still relatively new and often lack the scale that would make them appealing candidates for trade sales. Furthermore, international venture capitalists often rely on their global networks to facilitate divestment. But recessionary woes in the US and Europe are limiting opportunities to sell Brazilian start-ups to international corporations.

Another issue is that unlike emerging market peers China and India, the IPO market for small companies in Brazil is virtually non-existent. Efforts to create an exchange for this category known as the Bovespa Mais have yet to bear fruit, partly because small companies have difficulty complying with regulations. Since its launch in 2004, just three companies have listed on the Bovespa Mais. Only one of those, São Paulo-based Senior Solution (SNSL3M:SAO), is active in the technology sector.

Silicon Valley VCs scale back

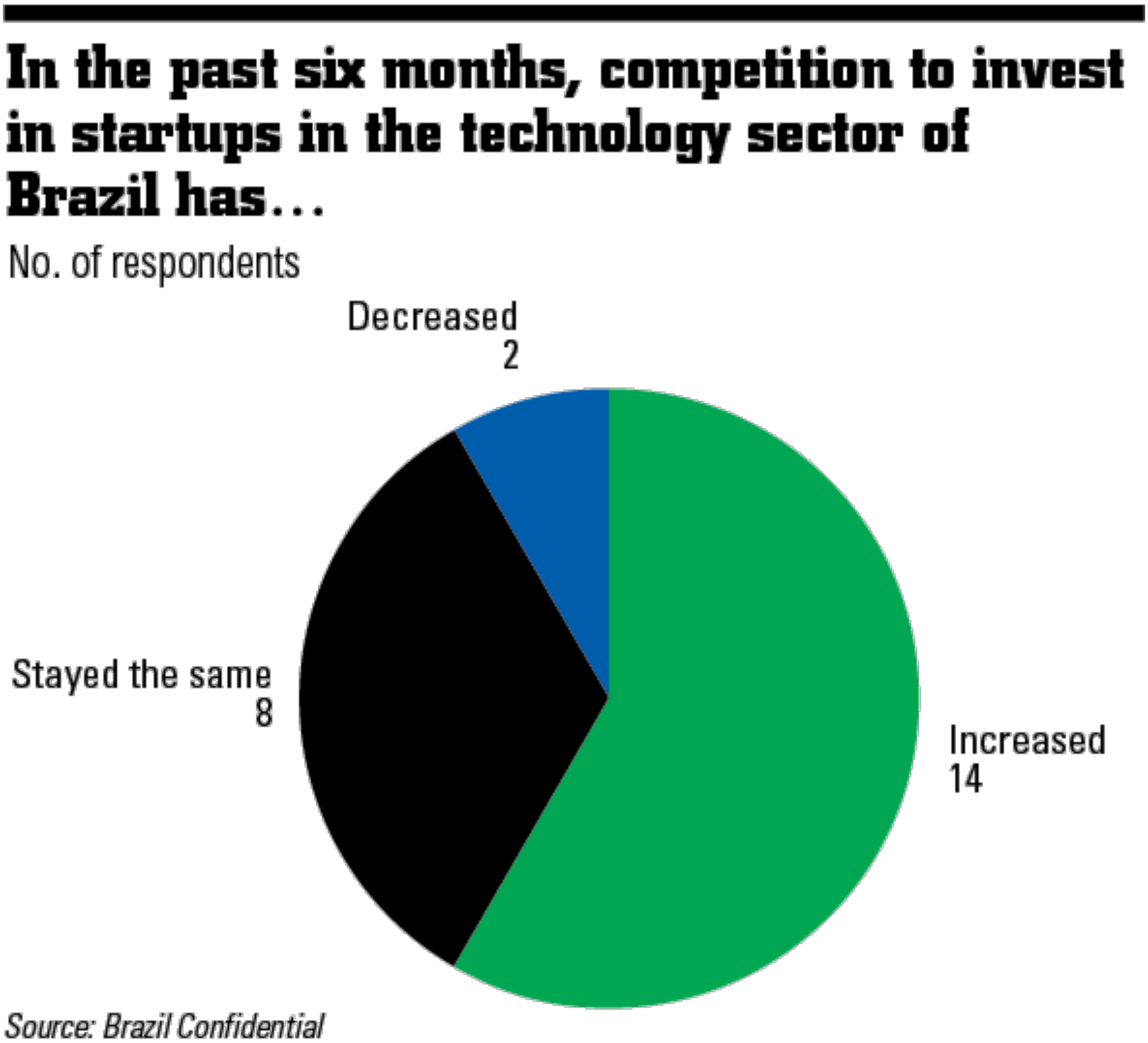
Such difficulties are spurring some Silicon Valley investors to pull out of Brazil, while others are becoming more selective about their investments. “Some people have gotten scared off because they couldn’t find opportunities,” said Kevin Efrusy, the head of Brazil investments at Accel Partners. “A lot of Silicon Valley funds that entered the market left, only a handful remained and invested.”

Eric Acher, a co-founder of venture capital firm Monashees Capital, similarly observed that the hype around investing Brazilian consumer internet startups has “cooled down”.

“The first wave of venture capitalists made a lot of investments and built portfolios in Brazil,” he said. “Now they want to see some results before investing more.” On the other hand, argued Mr Acher, a second wave of international venture capitalists from Europe and the US are now entering the market, partly compensating for the outflow. A majority of our respondents said that competition had increased in the past six months.

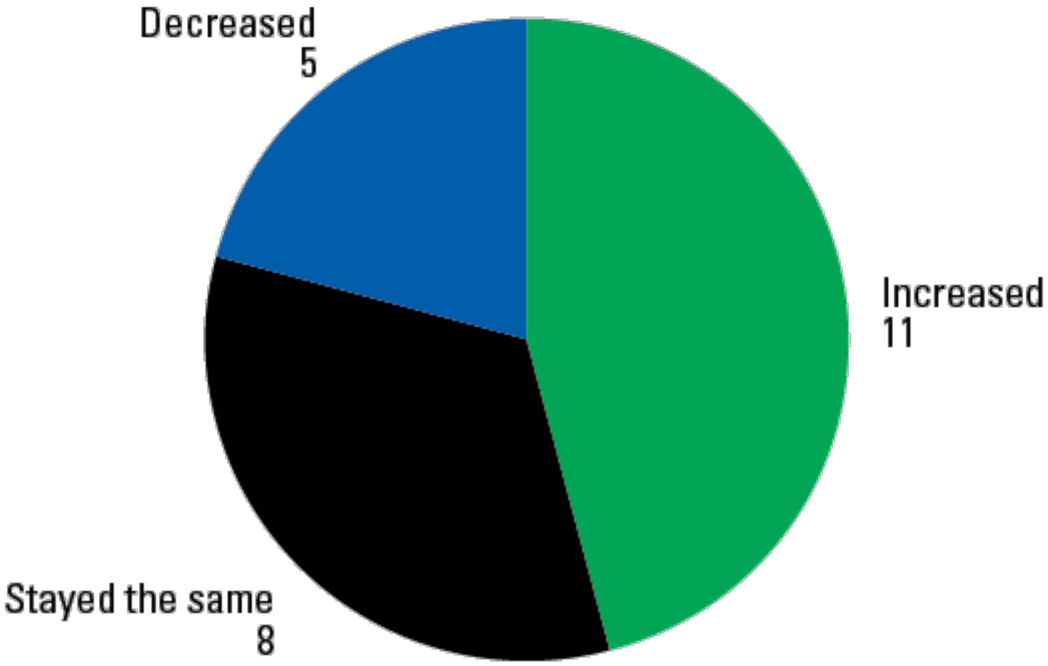
Intel Capital is one such example. It has been in Brazil since 1999, but increased its activity in the country this year, investing in health web portal Minha Vida, mobile start-up Pagpop and e-commerce fashion companies ELike, Coquelux and Fashion.me. It expects to close three more deals in the next six months, according to Intel’s investment manager for Latin America Fábio de Paula.

The less bombastic approach of international venture capitalists means valuations are unlikely to continue to climb. Our survey suggested valuations may already be coming under pressure. Although a majority of our sample (13 of 24) said pricing expectations had risen over the past six months, five respondents said they had fallen.


In the past six months, competition to invest in startups in the technology sector of Brazil has...
No. of respondents
Decreased
2
Stayed the same
8
Increased
14
Source: Brazil Confidential

In the past six months, companies' valuation expectations in the technology sector have...

No. or respondents



Source: Brazil Confidential

B2B gains appeal

Venture capitalists are also expanding investments in technology companies in the business-to-business (B2B) sector. "Six months ago nobody was talking about B2B… but it feels like that has changed very rapidly and a lot of people have their eye on the sector," said Jeff Levinsohn, a partner at business incubator 21212. Indeed, Mr Efusy told Brazil Confidential that Accel Partners has become "more interested" in B2B technology companies and other international funds are following suit.

Local venture capital funds have also sought out the sector as the market for internet and mobile-focused start-ups is viewed as becoming overcrowded and dominated by foreign funds with "deeper pockets". One example is Belo Horizonte-based Confrapar, which currently has investments in seven B2B start-ups and three business-to-consumer (B2C) start-ups, compared to a 50-50 split a year ago. "We'll focus more on B2B [companies] until the bubble in consumer internet is over," its chief executive Carlos Eduardo Guillaume told Brazil Confidential.

According to Mr Guillaume, valuations of technology companies in the B2B segment that Confrapar has invested in have stayed the same over the past five years, while valuations have risen by around five times for B2C companies. Alexander Schmitz-Kohlitz, a partner of German venture capital firm Akit Partners, similarly argued that in the B2C segment "there is less innovation for more money".

Brazil Confidential found that B2B-focused venture capital funds are eying opportunities in healthcare, education and financial services. Investors in the segment tend to form close relationships with industries, facilitating the process of divestment down the line. "Our strategy is to find out what the healthcare companies and the banks are looking to acquire, and create assets that might be relevant," explained Mr Guillaume. Similarly, Astella Investimentos has sought to "map the exit from the moment of investing," according to a partner at the firm, Laura Mello de Andrea Constantini.

Last month, Astella Investimentos divested from one of its portfolio companies in the education sector just two years after closing the deal. Brazil Confidential understands that the start-up was sold to a strategic investor, and the entrepreneurs will remain in the company. “The lifecycle was shorter than we were expecting because the entrepreneurs wanted to sell it,” noted Ms Constantini. Astella’s typical investment cycle is 3-4 years.

Bridging the gap

Finding investment opportunities in B2B start-ups can prove challenging for international investors that do not have a local presence. Whereas consumer internet companies tend to be based in São Paulo, B2B start-ups are more diversified geographically. Mr Guillaume said some of the best opportunities are in rural areas. Moreover, developing companies and exiting investments in the sector usually requires local knowledge and local contacts. Perhaps not surprisingly Argentina’s Nazca Ventures has been unable to find opportunities in the B2B market, according to its co-founder Eduardo Amadeo, who runs the firm from Buenos Aires.

Nazca Ventures aims to circumvent this obstacle by investing in start-ups in Spanish-speaking Latin America and then bringing these ventures into Brazil. According to Mr Amadeo, start-ups tend to be cheaper and more experienced in countries such as Argentina and Chile. Setting up foreign IT firms in Brazil gives Nazca access to the country’s vast and growing consumer market without the difficulty of finding local targets, said Mr Amadeo. So far, Nazca Ventures has invested in two Brazilian and Argentine start-ups and is currently in talks with an Argentine firm about setting up in Brazil.

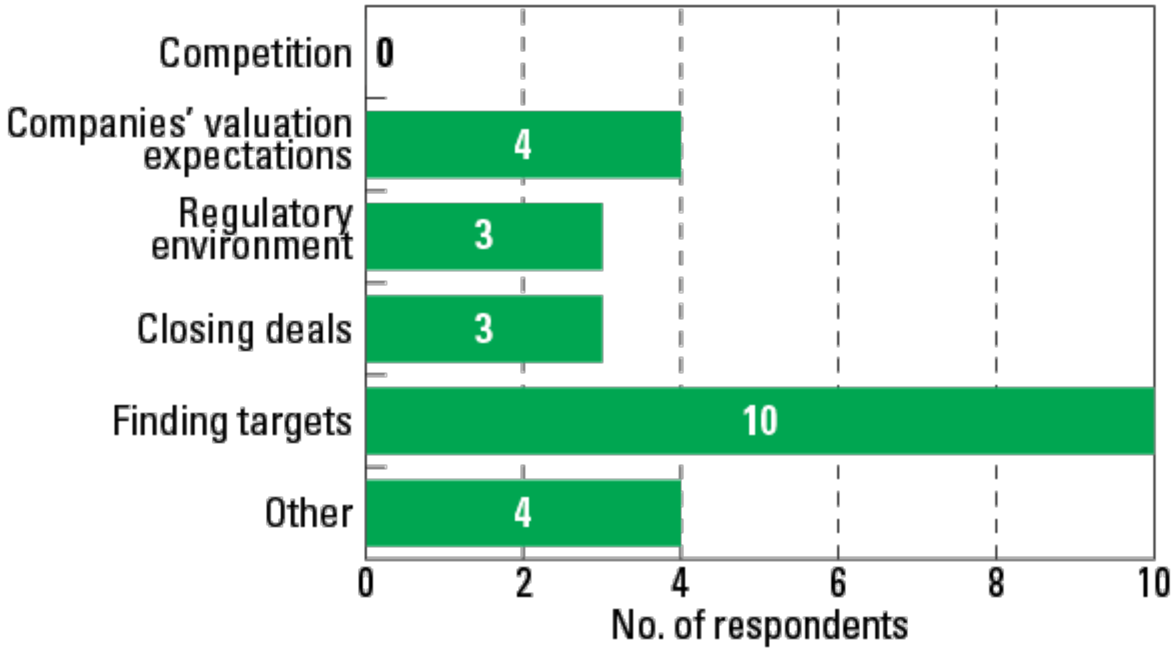
Other international players are partnering with local venture capital funds to tap into their knowledge of the local market. For instance, Paris-based venture capital firm Truffle acquired a minority stake in Confrapar in October this year. It plans to increase that over the next two years. According to Truffle co-founder Bernard-Louis Roques, the French firm was attracted by Confrapar’s “strong local presence” and the fact that it has offices across the country, including branches in Belo Horizonte, Curitiba, São Paulo and Rio. Confrapar is also launching a new fund in which Truffle will be an advisor. The Aventi fund aims to raise R$200m, of which the first tranche of R$100m is expected by the end of the year. It will invest in eight to ten companies with revenue of R$10m-30m.

Advance of the accelerators

Another challenge is the lack of professionalism among start-ups in Brazil, partly due to a deficit of advisers (known in the industry as mentors). According to data from Telefónica Digital and Startup Genome, São Paulo has one-third fewer mentors than Silicon Valley.

Yet the arrival of US-style digital accelerators is “changing the environment,” according to DXA Investimentos chief executive Oscar Decotelli. Indeed, although finding a target remains the biggest challenge for investors, in our survey 11 respondents said that finding targets had become easier in the past six months. The south and the south-east remain the most favoured regions for investments, although investors are looking elsewhere too.

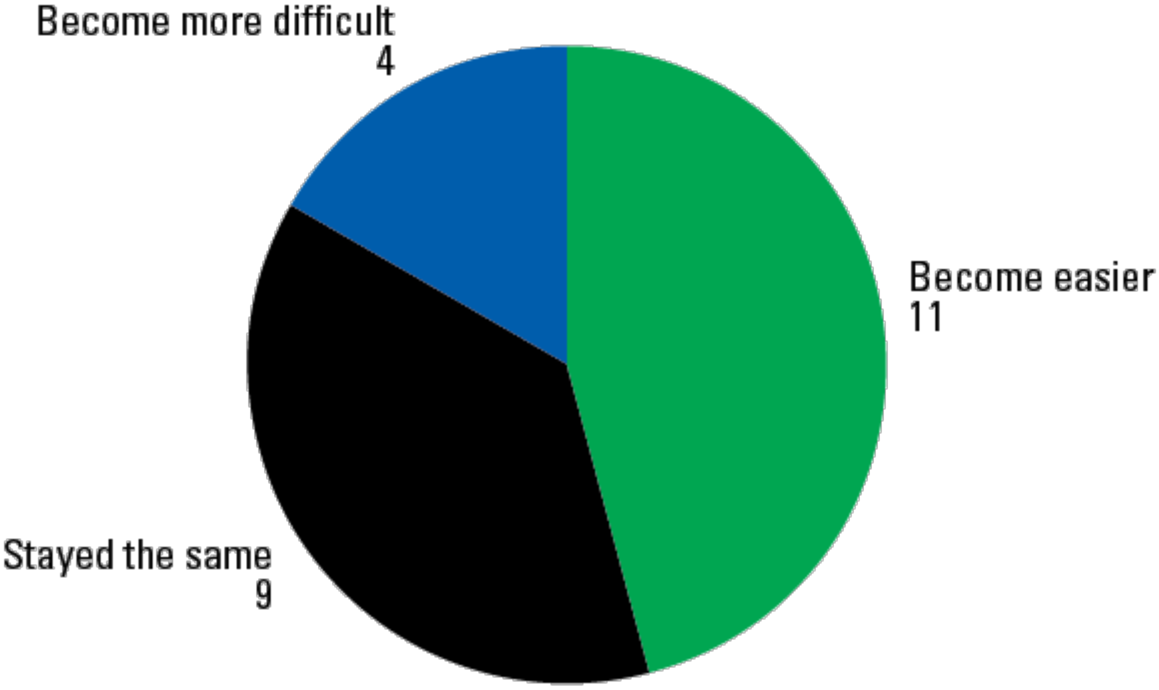
The main challenge for investors in the IT sector of Brazil is...



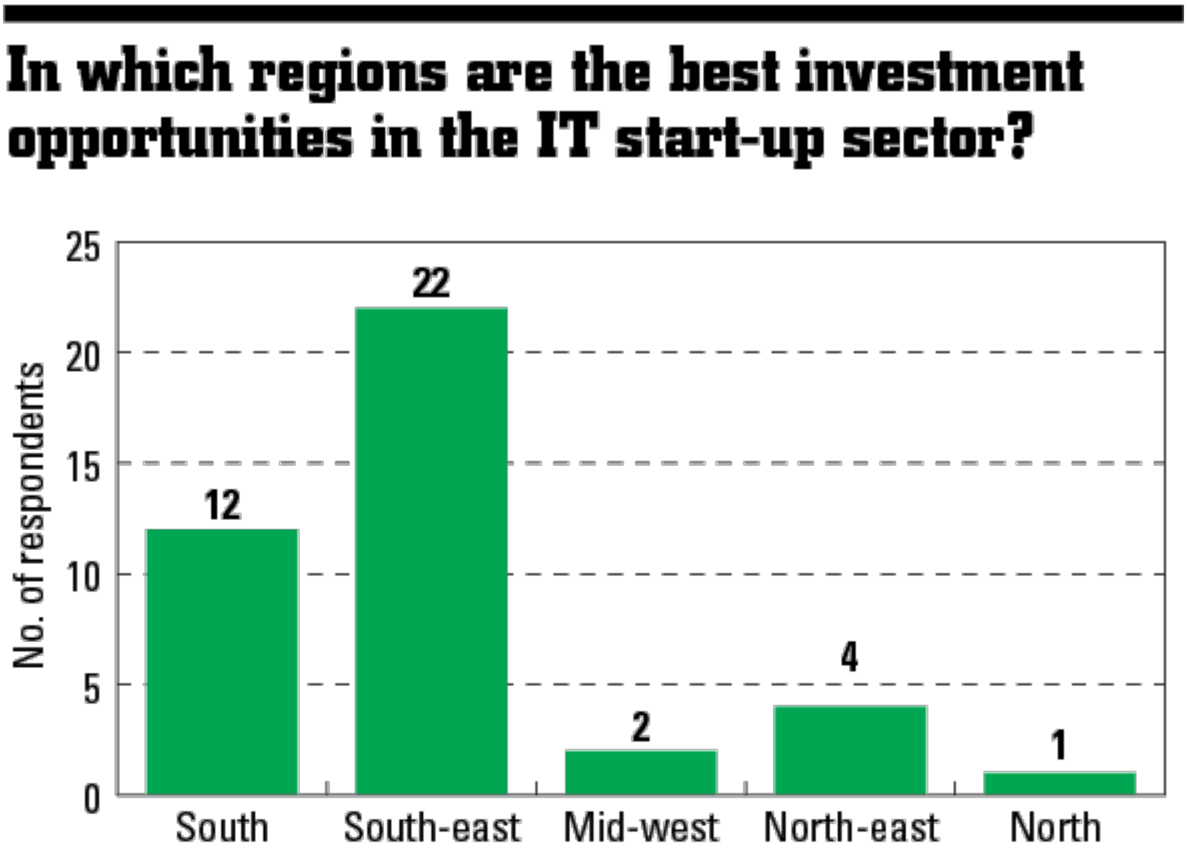
Source: Brazil Confidential

In the past six months, finding companies to invest in has…

No. of respondents



Source: Brazil Confidential



Note: Multiple responses possible
Source: Brazil Confidential

A pioneer in the segment is 21212, a digital accelerator formed two years ago by a group of American and Brazilian entrepreneurs. 21212, which is named after the city telephone codes of New York and Rio, has focused on bridging the gap between start-ups in the US and Brazil by applying international "best practices" to the management of embryonic Brazilian firms.

Accelerators tend to offer less financing than angel investors and seed capital funds. For instance, 21212 typically provides R$20,000 per company, or what Mr Levinsohn describes as "survival money". However, accelerators usually offer more hands-on help. 21212 enrols its portfolio companies in an intensive four-month training course where they are given workshops on everything from accounting to marketing their business on Facebook, the popular social media site. 21212's international connections also make it an attractive prospect for start-ups that have global ambitions for their company.

In the past six months, 21212 has invested in nine companies in Brazil and aims to invest in 30 companies in 2013. One of its portfolio companies, Pagpop, already received investment from DXA Investimentos and Intel Capital in October. Other accelerators that have emerged in Brazil in the past years include Belo-Horizonte-based Aceleradora, Papaya Ventures in Rio, and Appis, Startup Farm and Tree Labs in São Paulo.

Early stage companies also have more funding options. The drop in interest rates in Brazil has spurred an uptick in investment in technology start-ups by wealthy individuals, pension funds and family offices that have traditionally invested in fixed-income assets. Angel investor associations such as Gávea Angels, Jacard Investimentos and Cássio Spino's Anjos do Brasil are also expanding, and deals are becoming bigger as more angels are co-investing.

According to Antonio Botelho, the chairman of Gávea Angels, the association is "intensifying" its co-investments with funds in São Paulo as well as with investors in Europe and Argentina. It has invested in six start-ups since 2010, and aims to make between seven and eight investments next year. Jacard Investimentos and Anjos do Brasil are also focusing on co-investing with other angels, according to partners at the firms.

However, Brazil continues to have a funding problem for companies in the late stage of growth. São Paulo start-ups typically raise 86% less capital than their Silicon Valley peer, according to Telefónica Digital's November report. Mr Acher of Monashees reckoned that Brazilian investors focused on growth capital still lack the "right mindset". "They look at assets that are proven, that eliminate risk, and they pay for assets, not the ability of entrepreneurs to build great businesses," he said. "That still needs to change."