UNLOCKING THE NEXT LEVEL
Venture capital has gained momentum in Latin America – but are the stakes worth it?
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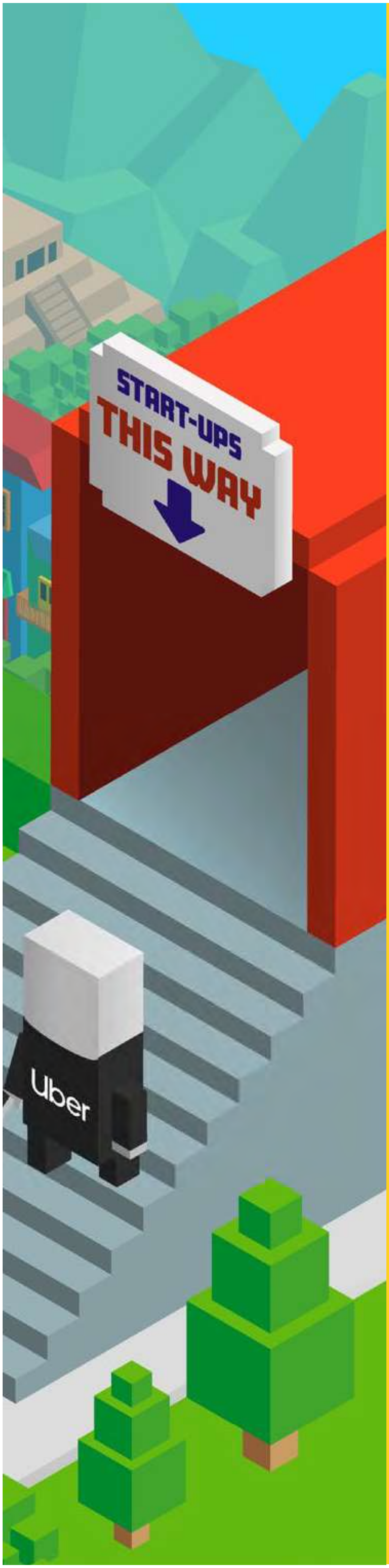


Latin America's venture capital scene has gained momentum during the past decade, with corporate venture capital now piquing the interest of multinationals, local companies and even some law firms. But the high-risk, high-returns nature of venture capital investment brings its own unique set of challenges and opportunities for lawyers advising on these deals. Are the stakes worth it, especially in these trying times?

by **CHRISTINA MCKEON FRUTUOSO**

When ride-hailing app Uber announced its intention to buy Chilean grocery delivery service start-up Cornershop for a reported US$459 million, the hefty price tag signalled one of the biggest returns for venture capital (VC) investors in Latin American history.

But that was back in October. Since then, it has been an uphill battle getting the deal through Mexican regulators, in particular (outside Chile, Cornershop is active in Mexico, Peru and Canada). The deal has laid bare the lack of precedents available for regulators to follow when policing deals involving start-ups.

Mexico's antitrust regulator spent months fighting its telecommunications counterpart to have the final say on whether the deal should go ahead. Cornershop's status as an online platform for delivery services led both agencies to stake a claim. On 22 May, the Supreme Court tribunal that handles administrative matters ruled unanimously in favour of the antitrust regulator. At the time of writing, official approval from the regulator for the deal was still pending.

Illustrations by Jade Nunes

Although it has prompted regulators in Mexico – and other jurisdictions – to try to better understand the e-commerce sector, the deal is indicative of a regulatory landscape in Latin America that is not hugely familiar with merger and acquisition (M&A) transactions involving start-ups, many of which have established themselves in niche fields and can be hard to define in traditional terms. "Many agencies are still educating themselves on how to handle these kinds of deals," says Daniel Green, a partner at Gunderson Dettmer's Silicon Valley office and one of Cornershop's advisers in the deal. The result is that the timing of regulatory processes for these deals can be more difficult to predict than in, say, the US or UK.

Even in Chile, where the VC market is considered more developed than in Mexico, clarifying the scope of start-ups to state agencies proved the biggest challenge for the deal's counsel. "Explaining new markets that are dynamic, like VC, is difficult – how do you properly explain innovation, since it has different meanings to different people?" says DLA Piper (Chile) partner Matías Zegers. "Agencies usually handle mergers of equals or established companies, but VC is hard because it has no real equivalents."

The huge returns that Cornershop's early-stage investors are set to receive from the sale mean observers have followed the deal closely. "Cornershop proves to Latin American VC investors that there are real opportunities for returns in the region," says Gunderson Dettmer's Green. "It shows that you can get returns that are 10, even 50 times your investment."

The deal forms part of an exciting narrative being told in Latin America right now. "The story hasn't been written yet," says Green, "but whatever happens, there's a lot more opportunity across different sectors for VC funds to invest."

THE CATALYSTS FOR GROWTH

Latin American VC had a record year in 2019. Some US$2.3 billion was invested in regional start-ups – up from US$143 million in 2011.

The growth of technology and connectivity during the past decade, explains Greenberg Traurig SC corporate practice shareholder Arturo Pérez-Estrada, is responsible for the boom, providing unprecedented opportunities to bring products and services to the "underserved" population at high speed and marginal costs. "As these innovations took hold, investors saw fresh and unprecedented access to markets and businesses that had not been viable options for them in the past," he says. "Once this trend became evident and new solutions appeared, capital flowed in."

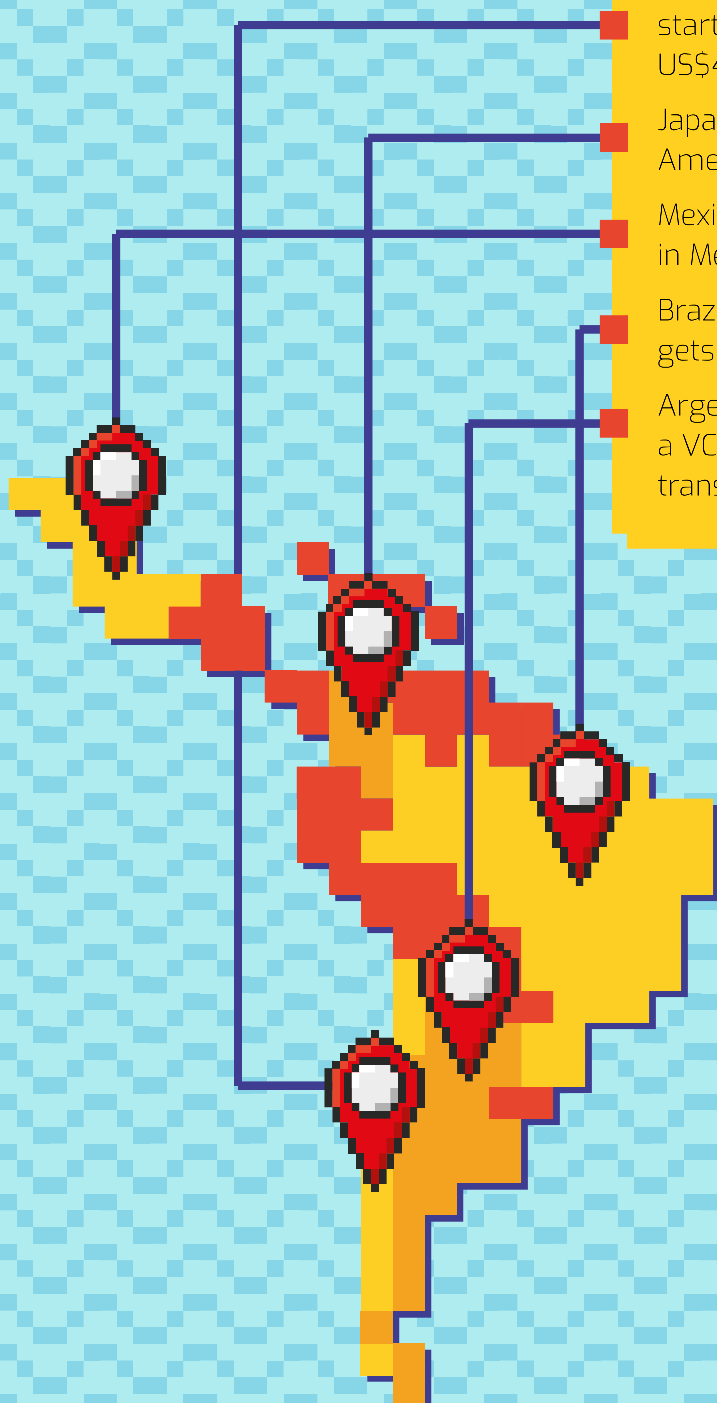
The region's changing demographics are also contributing to the growth in start-up activity. "There's a younger, more connected emerging middle-class economy in many major Latin American markets," says Morrison & Foerster partner Randy Bullard. "These markets have been fertile soil where technology companies have been fuelling investment in larger numbers than before."

Many law firm partners attribute a recent spike in VC activity in Latin America to Japanese investor Softbank's US$5 billion innovation fund, which launched in March 2019. Softbank is seeking to fuel Latin America's relatively young VC market by partnering with local funds, including Brazil's Valor Capital

IN THE NEWS

Big VC deals in Latin America from the last 18 months:

- Uber acquires Chilean grocery delivery start-up Cornershop for a reported US$459 million
- Japan's SoftBank invests US$1 billion in Latin American food delivery start-up Rappi
- Mexican VC business Angel Ventures invests in Mexican geolocation start-up Decifra
- Brazilian healthcare start-up Conexa Saúde gets investment from e.Bricks Ventures
- Argentine energy company YPF launches a VC fund for disruptive energy and transport technologies



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Today Brazil has 11 unicorns, including fintech Nubank, ride-sharing app 99 and – most recently – real estate start-up Loft.

and Argentina's Kaszek Ventures. Its most memorable moment came in April 2019, when it plugged some US$1 billion into Colombian start-up delivery app Rappi. Bullard describes this deal and the creation of SoftBank's Latin American fund as "transformative moments" for VC investment in the region.

VC prospered in Latin America during 2019 despite the political and social unrest that swept various countries. This prosperity includes the creation of 12 unicorns (start-ups valued at more than US$1 billion), one of which was Rappi. This is illustrative of VC's robustness during a troubled period when the growth of more conventional industries might be expected to be hampered, as has been observed in the past. "The VC cycle in Brazil survived the 2014 Brazilian recession and proved the theory that this industry is not impacted by the broad economy of a country," says Pinheiro Neto partner Raphael de Cunto. "We actually had the biggest growth ever after 2014, with the birth of the Brazilian unicorns." Today Brazil has 11 unicorns, including fintech Nubank, ride-sharing app 99 and – most recently – real estate start-up Loft, which achieved that status in January.

The size and sophistication of the Brazilian market has made it an obvious choice for VC investors looking at the region and almost all the region's unicorns are Brazilian – but other countries are carving paths and finding success too.

GOVERNMENT ACCELERATION

Chile – considered by many as a leader in Latin America's start-up ecosystem – was the first country to offer a government-backed start-up accelerator. Start-Up Chile has successfully fostered the growth of these businesses since 2010. The programme is managed by state development agency CORFO, which also has regulatory oversight of VC funds.

In the past three years alone, the programme has provided early-stage loans worth a total of US$55 million to more than 300 start-ups. They carry competitive interest rates and have flexible repayment plans, which appeals to borrowers. These loans, combined with private investments, have raised around US$998 million in funding for start-ups. "Start-Up Chile has built an excellent Chilean ecosystem of start-ups," says DLA Piper's Zegers. "Investors now realise that VC is a way to build up verticals in our economy, which was the government's aim back in 2006, especially to advance the biotech and technology sectors," says Zegers.

Chile has no laws specific to VC or start-ups but the country has a clear tax structure and a rule of law that serves to keep bureaucracy to a minimum. This includes a 2007 policy that approved a new structure under which companies could incorporate: the company by shares "SPA" model removes liability for investors should the company run into financial trouble. Colombia has an equivalent model known as "SAS".

Peru is also considered a relatively good place to start a business. Innóvate Perú, inspired by Start-Up Chile, finances the country's start-ups through loans at low interest rates, mainly at the pre-seed investment level. Digital real estate platform Valia is just one of the start-ups to have benefited from this programme.

As is the case in Chile, Peru's state-backed development bank COFIDE has an important role. In early 2020, Peru's government submitted a law that proposes creating a master fund under the management of COFIDE that would allow VC funds to group together to provide investment at later stages to Peruvian start-ups, including those that have already "flipped" (incorporated) abroad but have operations in Peru. The regulation is pending, awaiting government approval.

"This is to try to close the gap between seed capital and later growth stages when companies traditionally go abroad," says Rebaza, Alcázar & De Las Casas partner Alexandra Orbezo. "We're trying to push to have broad enough regulation to create more opportunities for start-ups to scale both regionally and globally."

TOP TIPS FOR VC DEAL-MAKING

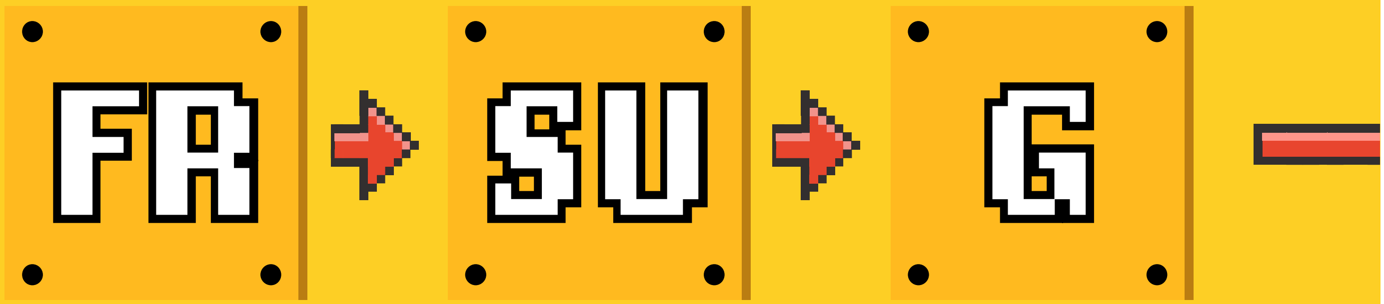
Work with both sides to gain a broader perspective of what each party in a deal wants. "We get stronger at our respective disciplines that way," says Daniel Green, a partner at Gunderson Dettmer's Silicon Valley office. "If I work with a VC fund, I am better able to help a start-up anticipate what their investors will want, and vice versa."

Separate compliance from legal and business growth plans "so you don't have a compliance officer constantly saying no," says Tanoira Cassagne Abogados partner Manuel Tanoira. Lawyers must show investors why this is the best option in the long term. "It's common for start-ups to not have compliance at 100% in the beginning. With business growth, it can then focus more on compliance," says Marval O'Farrell Mairal partner Hernán Slemenson. "VC investments are more focused on the key contingencies from a due diligence perspective and will naturally accept more risk," he adds.

Expect things to move fast. Start-ups need investment to survive and founders – who are often exclusively focused on their projects – are willing to take big steps. "The speed of these deals is amazingly quick because any delay may literally cause the bankruptcy of the start-up," says Carey partner Francisco Guzmán.

Be a lifeline for international investors navigating foreign markets. "There are terms and practices that may be new to them. Our role is to be a bridge between the expectations and requests of the foreign investor and the local start-up looking for financing," says Carey's Guzmán.

VC FUND: THE INVESTMENT PROCESS



Fundraising:
General partners raise money from different limited partners

Start-up investment:
VC fund typically invests in early-stage start-ups

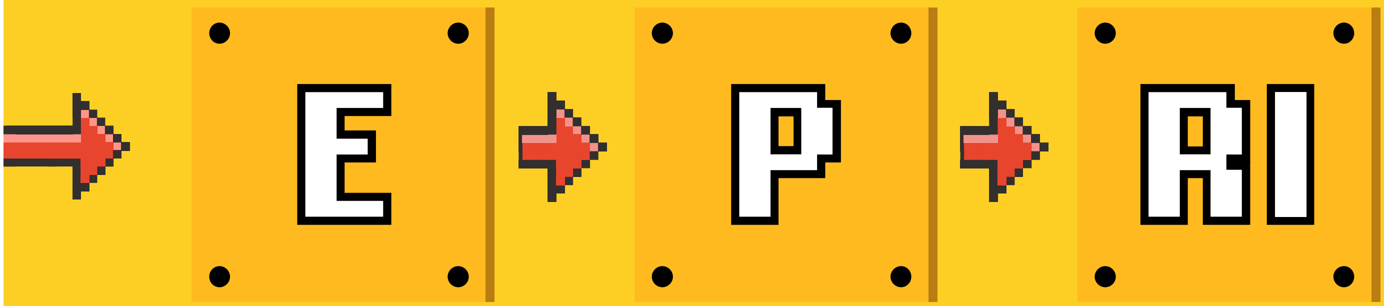
Growth:
VC fund helps start-ups to grow and takes active role in management and corporate governance of the start-up

The region's legal landscape has adapted to attract and maintain VC activity, especially in the past five years. For example, in 2017 Argentina passed a law that established tax incentives for VC funds and corporates investing in start-ups. It created a national trust fund that enables private sector players to invest alongside the government in new projects in a streamlined process. It also made business registration a lot quicker, incentivising individuals to found their own companies.

Countries with governments that have directed efforts into cultivating start-ups and VC activity are in a good position to build a VC ecosystem. But in jurisdictions where this has not been evident, such as Central America, innovation and early-stage investment are still stifled. For any ecosystem to survive, its environment must be nurtured and maintained, or its biotic factors move elsewhere.

THE NEED FOR NURTURE

Several hurdles make VC investment in Latin America relatively difficult. Investors across the region are unwilling to be charged high tax rates on their investments. Peru has different levels of capital gains tax for foreign investors and locals – currently, a foreign VC fund or investor that sells shares in a Peruvian start-up must pay a 30% tax on those returns. Local corporations pay fractionally less, whereas individuals are charged 5%. Lawyers are calling for a new tax law to level the playing field. In Colombia, by contrast, foreign investors who hold shares in start-ups for a minimum of two years are given more favourable tax rates when they sell.



Exit:
VC fund gets returns through an "exit" – usually through a merger or acquisition or an initial public offering

Profits:
VC fund delivers returns to their limited partners

Reinvestment:
Limited partners may choose to reinvest in the fund

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In Brazil, a law amended at the end of 2019 boosted the use of participation funds (FIPS), a type of closed-end investment structure that encourages investment in small businesses by allowing foreign investors to benefit from 0% tax on operations of credit, exchange and insurance (imposto sobre operações financeiras), which is applied to financial transactions, including investments.

FIPS were created in the context of private equity and although they do benefit VC, critics say there is room for Brazil to do more. "Regulatory frameworks that facilitate specifically VC activity could push our VC ecosystem from being a good one, to a great one," says Pinheiro Neto's Álvaro Uliani Martins dos Santos.

Cases in which judges have targeted investors' assets amid corporate bankruptcy are evidence of Brazilian companies piercing the corporate veil.

But there are other hurdles to overcome. For one, Brazil is a notoriously difficult place to do business. "It's still hard to open an entity and liquidate here in Brazil," says Mattos Filho partner Marina Procknor. Despite the recent temporary amendments to its bankruptcy law as a result of the covid-19 pandemic, Brazil's insolvency laws still make investors hesitant. Interpretation of the laws has traditionally seen labour and tax courts

For every Rappi or Cornershop, there are hundreds, even thousands, of failed start-ups.

go after the assets of individual investors alongside the assets of insolvent companies. "VC is about investing in 100 companies," says Procknor. "If you are lucky, one will be good and it will make up for the other 99 failures, but we don't yet have bankruptcy and insolvency laws that make this attractive and worth the risk."

Bureaucratic processes that make financial success long and difficult to obtain put investors off, and the high-risk nature of VC multiplies this deterrent because these investors have much more to lose. Cases in which judges have targeted investors' assets amid corporate bankruptcy are evidence of Brazilian companies piercing the corporate veil, which makes investors uneasy; they don't want to be liable for any start-up they invest in going bust at a later stage.

"We need better interpretations of the laws we have, so VC investors are not worried about whether they will need to use their own assets to pay for the obligations of the companies they invest in," says Procknor, though she adds that despite the challenges, Brazil's VC sector continues to grow rapidly. "We have a business environment more aligned with international jurisdictions, which makes all the difference. I am optimistic, as we have a breeding ground for business."

THE F-WORD (FUNDING)

VC is a notoriously fickle industry thanks to its high-risk, high-return nature. Funds targeted at the region tend to be structured offshore, because the certainty they and their investors get from tried-and-tested models – including for tax and corporate liability – in jurisdictions more accustomed to VC helps validate the risk.

"For VC investors, the number one concern of doing business locally, certainly in Brazil, is that for every dollar they invest, they are willing to lose it, but not a dime over it – they don't want to be worse off than when they started," says Veirano Advogados partner Sergio Bronstein. "For that reason, they prefer to set up their funds offshore so as not to run the risk."

Delaware, Luxembourg and the Cayman Islands are among the most popular locations.

In the early and middle stages of a start-up's life cycle, capital often comes from local sources – angel investors, local VC funds or government-backed accelerator programmes (in countries where they exist). But Latin America lacks widespread big-ticket investment. Start-up investment can be uncomfortable territory for some. For every Rappi or Cornershop, there are hundreds, even thousands, of failed start-ups.

There are ways to bridge the gap between international investors, who typically dominate later-stage VC investment, and local ones, who pull the wagon in the early stages. International players often look for local partners – whether funds, angel investors or individuals – to team up with.

Cornershop received series B funding from a consortium of investors, including US fund Accel and Mexico City-based group ALLVP. The balance of foreign and local is mutually beneficial, and Gunderson Dettmer's Green thinks this kind of collaboration will grow in popularity. "International investors generally don't know the local market as well as the local ones; having a VC lawyer who understands the local business landscape proves invaluable," he says.

UNDERSTANDING DIFFERENT PLAYERS

VC lawyers understand that the key concepts at play in VC investment are economics – price and revenues – and control. It is also vital to understand the thinking of the different parties involved in VC spending.

Both sides of the negotiating table – start-up founders on one side, investors on the other – often want to feel in control. Egos can complicate things. This can leave lawyers feeling like mediators.

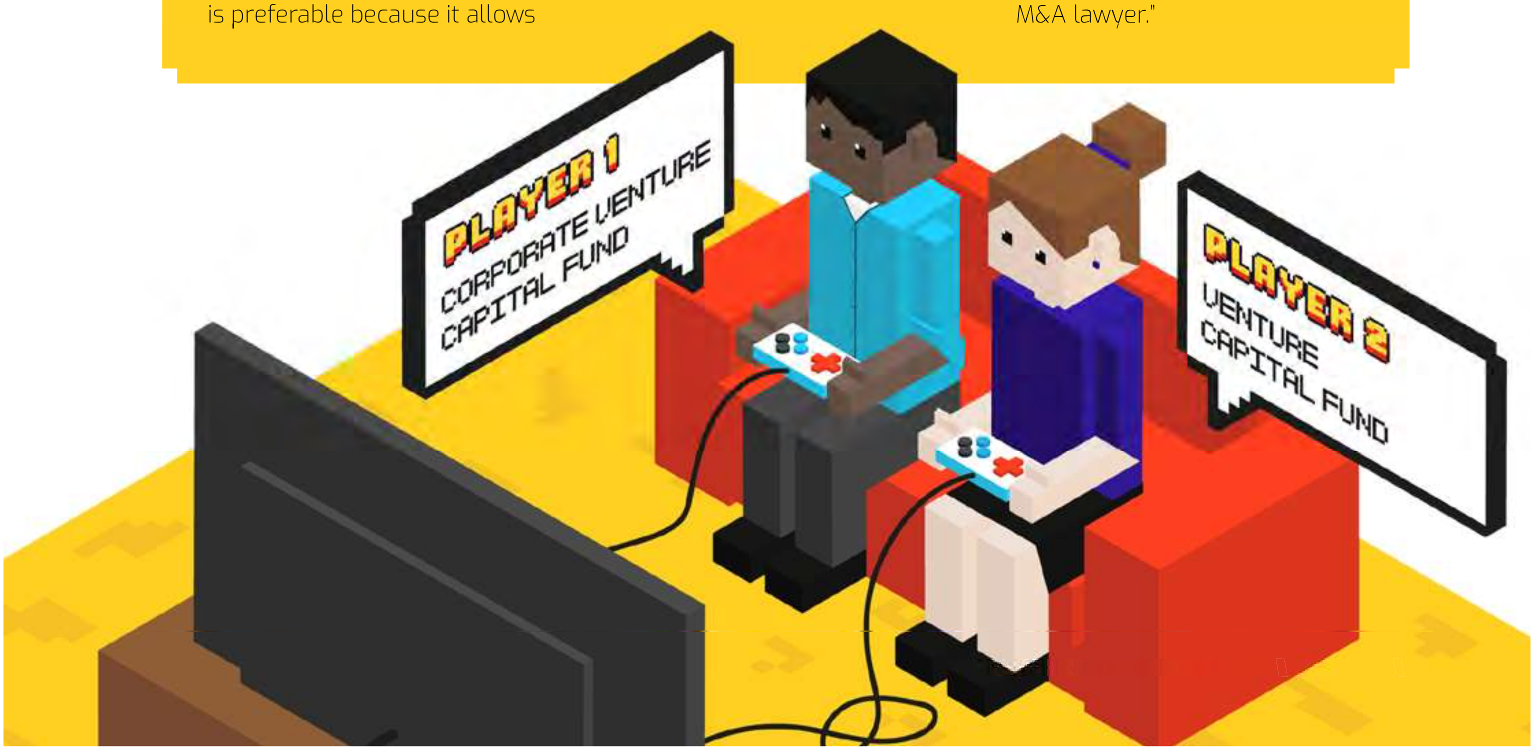
"You can have a company founder who has quit a high-flying job to dedicate time to the project – they tend not to like being controlled," says Rebaza Alcazar's Orbezo, "but you also have the investors, who put their money in the company and equally want to have some sort of control."

Finding a balance isn't always easy. One option is to manage the expectations of investors, who may be new to VC. As Rodrigo, Elías & Medrano Abogados partner Augusto Cáceres Vega explains, you need to "tropicalise an investor's thesis" when it comes to VC activity. Little and often, at least for early-stage investment, is key. Unlike traditional M&A or private equity, being a minority – rather than a majority – shareholder in a start-up at the early stages of growth is preferable because it allows more access to a divestment in the future, which is paramount.

More experienced VC investors tend to be the ones that delve into later-stage investment. They are also usually more aware of the nuances of this field. "From my experience, VC funds tend to play fair – they understand the complexities of VC investment and want to see the start-up they're investing in thrive," says Pani Abogados partner Joaquín Pani. "I'm not saying that private equity players play unfairly, but VC investors want all sides of the deal to win and, in that sense, they may seem more noble than traditional investors."

Sometimes it is the entrepreneur who needs extra guidance from counsel: they naturally want their start-up to receive investment as quickly as possible and sometimes do not initially understand the finer details.

"The lawyer really has to take the lead for the founder to guide them through everything," says Pani, adding that the job of legal counsel goes beyond legal. "You have to advise them on day-to-day operations. Sometimes, there isn't even a financial adviser at the start-up, so you have to wear your money hat. It's arguably a much more comprehensive job than that of an M&A lawyer."



FEE FLEXIBILITY FOR START-UPS

Start-ups often have to foot the legal bill of their VC investors and some international funds request big-name law firms for insurance purposes – so legal fees can rack up quickly. Hourly rates are never favourable for start-ups and fee flexibility is key if a firm wants to attract entrepreneurs as clients.

From delayed payment schemes to payments in instalments, firms are being inventive. Mexico's Pani Abogados offers start-ups a "bag of hours" structure under which the client agrees to a set number of hours for the month ahead. Lawyers then deduct from the "bag", prioritising the most important work for the individual client and being cost-efficient and pragmatic about what work they do. The firm also decides fees with individual clients.

"Our fee flexibility is because we want to optimise clients' costs and establish long-term relationships with them; we have to earn their trust," says partner Joaquín Pani.

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Regional VC funds are uncommon, but local and international funds are drawn to regional start-ups. "Because of the size of individual markets in Latin America, no investor is interested in a start-up that works in only one country. They look for something that can grow, at least to the primary markets of the region," says Rodrigo, Elías' Cáceres. It's common for start-ups in Pacific Alliance countries to expand across the bloc. "We all have similar markets, with similar cultures, idiosyncrasies and consumer needs that can be solved through technology, so once you enter one, you can enter the others easily," says Rebaza Alcazar's Orbezo.

But for companies to reach that level of scalability, investment in start-ups needs to be commonplace at all levels of funding – and that is not yet the case for Latin America. It's a vicious circle – big-ticket investors are deterred from investing by the lack of other big-ticket investors – but the cycle can be broken. Japan's Softbank is bucking the trend with its region-focused fund and other multinational investors have clocked on too.

THE FUTURE IS CORPORATE VENTURE CAPITAL

Direct investment made by companies in start-ups is picking up speed. By putting some of their business' capital into a fund dedicated to supporting start-ups, companies are helping to bridge the gap between early-stage government-backed investment and later-stage big-ticket investment, with a view to cultivate the region's innovation and to make healthy returns themselves.

A new generation of business owners is realising the benefit of having corporate venture capital (CVC) funds. In today's competitive markets, it pays

Changing the mindsets of traditional local business owners is a challenge in jurisdictions where family groups still hold the majority stake in corporates.

to divest your interests. "A well-balanced portfolio will include VC – there is a high chance you will lose some investments, but others will balance the losses," says DLA Piper's Zegers.

Brazil's Banco Itaú, for instance, is a large sponsor of accelerator Cooboo, which invested in tech start-up Zup in November 2019. "Now, more traditional Brazilian conglomerates are joining the club and setting up their own corporate VC funds," says Veirano partner Guilherme Potenza.

Other countries in Latin America are home to companies doing similar things. Argentina's state-run energy company YPF launched a VC fund focusing on disruptive technologies involving energy and transport in June 2019. Argentine online marketplace company Mercado Libre and Mexican food business Grupo Bimbo are other examples of corporations with VC funds dedicated to innovation.

Tanoira Cassagne Abogados partner Manuel Tanoira compares CVC to GPS tracking an industry. "Big companies need to stay afloat and know what the businesses of the future are doing now," he says. "It isn't just old companies investing in new ones – every innovative company has a corporate venture capital branch. Many companies are still late to this wave and are at risk."

Not only companies are getting involved. Peruvian firm Rodrigo, Elías & Medrano Abogados partnered with accelerator Liquid Venture Studio (LVS) two years ago to launch the LVS Legaltech Challenge, an acceleration programme looking for legal tech start-ups across Latin America to compete for access to the programme for the chance of follow-on investment. The firm has so far successfully helped a digital aviation dispute resolution start-up to launch.

"Corporate venturing in general is becoming sort of a trend now, so it makes sense other law firms will eventually look to collaborate with start-ups," says partner Augusto Cáceres. "It's still quite new for firms, but it's an opportunity more will be taking in the near future, which is good for the ecosystem."

CVC has been slower to catch on in some smaller economies. Changing the mindsets of traditional local business owners is a challenge in jurisdictions where family groups still hold the majority stake in corporates. They are sometimes uninterested in investing in high-risk

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>
> – *Manuel Tanoira, Tanoira Cassagne Abogados*

projects if they do not bring short-term profits. In Central America, many family offices have dominated markets for generations and this grants them a large amount of wealth leverage, says Carlos Miguel Rivas, lawyer and founder of El Salvador start-up Hardmode Interactive. However, there are some third- and fourth-generation family members who want to make their companies more financially sophisticated. "They're willing to take on the risk that VC brings," says Rivas.

A STING IN THE TAIL?

There is now deep concern that the declining macroeconomic prospects of many Latin American jurisdictions as a result of the covid-19 pandemic will deter investment in the region. The experience of Softbank is especially sobering for VC. Despite the 20% targeted rate of return it was hoping for, Softbank has grappled with an average return of -6% on its investments in Latin America, largely because of the slowdown – or complete standstill – of sectors such as transport, hospitality and retail during the global health crisis.

But there are indicators that VC activity could remain intact despite the pandemic. It could be a false positive, says Gunderson Dettmer's Green, but VC lawyers have so far been kept busy. "Early-stage investment activity, including series A and series B funding, tends to be active in crises; early-stage VC investors are looking for five to seven years before they exit their investment, so they can afford to weather a few more economic storms than traditional M&A or capital markets investors."

Importantly, the focus of VC investment – start-up companies – have proven to be resilient to negative circumstances in the past. Mercado Libre, for example, was founded and grew against the backdrop of the Argentine economic crisis in the early 2000s, finding success at a time when the country was under immense pressure. Indeed, the Argentine spirit and gusto for innovation in the face of adversity is what has given the nation its reputation as one of the most resilient in the region.


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New businesses face the same pressures as other corporations trying to survive this crisis – perhaps more so given their relative lack of liquidity. Nonetheless, the region's start-ups have squared up to these challenging circumstances. Hardmode Interactive, for example, is an app that allows El Salvador citizens to track areas that are deemed high-risk for covid-19. It acts as a communication channel between healthcare experts and the public. "We believe the app can be used to aid different health crises, as many of the app features can be adapted for regular public and private health users' activities," says founder Rivas. "We've had to reinvent ourselves before and we can do it again."

Meanwhile Rappi, despite cutting 6% of jobs at the beginning of 2020, has soldiered on amid profit concerns, demonstrating the same resilience and adaptability that helped it achieve unicorn status in the first place. The delivery app is currently selling covid-19 tests in Brazil and for every test purchased is donating a test to someone unable to afford one themselves. This durability encapsulates the essence of what Latin American start-ups can offer.

Both these examples show that the covid-19 crisis is an opportunity for innovative thinkers to present corporate solutions to sociopolitical issues that desperately need addressing. To get these ideas off the ground, CVC can help to plug the gap between early-stage local and later-stage international VC investment.

"We need new solutions for problems we are going to have as a society globally even long after the pandemic peaks," sums up Tanoira Cassagne's Tanoira. "Coronavirus has accelerated a digital transformation that is well on its way but we can foster it further through venture capital. Now is the time."

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