Investing in Venture Capital - An Untapped Opportunity for Brazilian Investors

This article analyzes how changes in investment trends following the 2008 Great Recession increased investment opportunities in the private markets for Brazilian investors. The recovery efforts had a long-lasting, profound impact on financial products' diversification and investment structures. Included in these is venture capital, which became an important asset class and is being increasingly used as part of a successful asset allocation strategy.

The changes in private market dynamics seem to be permanent and continue to impact the innovation and technology landscape in the world – and, particularly, in Brazil, will change the way investment portfolios are structured for investors.

How did this shift begin?

Up until interest rates hit their lowest historical levels worldwide following the recovery from the 2008 financial crisis, most Brazilian investors were not used to the high volatility associated with risky assets. As double-digit inflation rates and fiscal risk had historically kept interest rates at high levels in the country, fixed income returns had always been more attractive and financially prudent.

As a result of economic reforms implemented in the country, Brazil's economy became more stable in 2016, and the country's risk level decreased sharply up until 2020, when the pandemic hit. This event triggered a financial deepening, characterized by more diversified and complex investment products to meet the new demand.

Alternative investments and offshore products became a part of wealth advisors' day-to-day lexicon. While from a **macroeconomic** perspective, investing in private markets—private equity and venture capital funds—became more attractive to Brazilian investors, from an **asset allocation** point of view, investing in private companies and startups became easier as more funds with higher potential returns became available.

Why the higher potential returns?

The higher potential returns in the private market can be explained by a widely known trend: **companies are staying private longer**. While this is not new, it results in reduced premia for public market investors and increased value for early investors. In his book Secrets of Sand Hill Road, Scott Kupor[1] offers the Microsoft vs. Facebook example to illustrate this phenomenon.

Microsoft went public in 1986 with a $350 million market cap; since then, it's increased more than 2500x in valuation. Facebook, on the other hand, went public in 2012 with a $100 billion market cap and has increased in value 5x. This comparison needs to account for time frame, inflation, economic cycle, and other factors. However, all things considered, private investors captured much of Facebook's increase in value before it went public.

Companies are staying private longer for two main reasons:

Availability of funding following the ERISA[2] in the US, which enabled pension funds to invest in the alternative-investments space and VC funds for a steadier flow of capital, making it easier to access capital and not have to go through the hurdles of an IPO.

Reduction of initial costs to start a company went down sharply especially after the dotcom bubble. A classic example is cloud computing. After the 2000s, it became much cheaper for companies to build their operating systems as they did not need to buy and operate expensive servers. This trend is even more pronounced now as a number of startups have built solutions for one another: from automated payroll to corporate credit cards. The ecosystem now feeds on itself.

Is investing in VC a passing fad?

Some investors and financial experts believe we've reached a point of no return in which VC funding and startups have hit a new level of economic relevance. For others, they predict this is a bubble in

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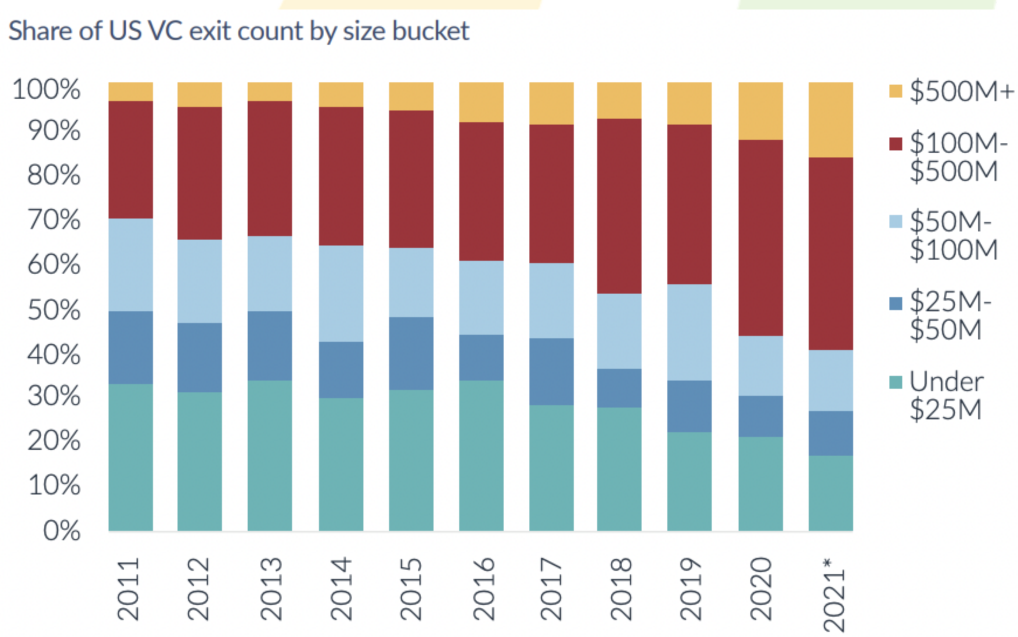
[1] Managing Partner at Andreessen Horowitz, co-founder and co-director of the Stanford Venture Capital Director's College

[2] 1974 Employee Retirement Income Security Act

the making and we should expect a mean-reverse movement at some point. While there might be a valuation correction on the horizon, as interest rate hikes are a reality now in the face of rising inflation, what we are seeing is not a passing fad but a huge structural shift in the way markets innovate that is only gaining momentum. Innovation is no longer centered in the R&D departments of large corporations, but made possible through startup ideas, trial and error exposure, and survival of the fittest. Provoked by technological advances associated with the internet and use of smartphones, the push for this innovation boom has enabled thousands and thousands of new products to spread across sectors.

The strength of this structural shift is well supported by data. **Graph 1** shows how much exit values have been growing over the past 10 years, with the $100-500M bracket being the largest since 2017. Valuations are indeed high across markets, but VCs are able to capture a sizable portion of the increases, with IPOs constantly underperforming, as shown in **Graph 2**.

Graph 1



Source: Pitchbook & NVCA Report: Q4 2021 Venture Monitor.

https://files.pitchbook.com/website/files/pdf/Q4_2021_PitchBook_NVCA_Venture_Monitor.pdf#page=1

Graph 2

Source: https://pitchbook.com/news/articles/2021-ipo-exits-market-charts

Why startups?

The startup boom came to accelerate the overall pace of innovation and fill a void, the creative destruction, as Joseph Schumpeter would put it, that has become prevalent at big companies.

Four main reasons led startups to become the center for innovation. First, it is now **cheaper to start a business** than it was before the tech boom. Technology infrastructure, one of the largest capital expenditures for a nascent company, is now extremely affordable. Cloud computing is an example, as mentioned before. By not having to buy and operate huge and expensive hardware facilities, businesses have become less risky. It also makes angel investing more affordable, with smaller check sizes. Ideas have thus started to move from paper to reality.

Second, with fewer hurdles, fewer processes to follow, and fewer hierarchies to go through, startups are **quicker to react and more responsive to change than big companies**. They are structured around their solution, instead of the contrary.

Thirdly, it's **easier now to reach customers**. Customer acquisition was also a great hurdle for nascent companies, which hindered scalability. Then came smartphones. Their greatest innovation was not only their revolutionary hardware, but the possibilities it enabled for the development of new solutions for a larger customer base. By creating an app and including it in the Apple Store, incredibly, a company has instant access to millions of Apple phone owners and potential customers.

Finally, the most impactful difference is in the **alignment of incentives** for innovation and new, bold ideas. And that is why this new structure is sustainable. At their roots, many large companies cultivate a culture of risk-averse managers who prefer to stick to what is working rather than try new things and risk their bonuses on challenging projects. By contrast, the startup ecosystem is structured to incentivize and support big risks and big rewards. From the founders who are chasing their golden pots on the other side of the rainbow; to the VCs funding and advising the best startups in hopes of good returns for the LPs; to early employees buying into the startup's mission and betting their careers for the chance of a big payout in the future. Not to mention a world of advisors and mentors who profit from and contribute in countless ways to the existing cycle.

This virtuous circle is a powerful engine for **value creation**. For investors, ignoring private companies means leaving money on the table and waiving participation on the most profitable part of the cycle.

Public markets also benefit from this system. According to a study conducted by the Stanford Graduate School of Business Professor Ilya Strabulaev[3], VC-backed companies are 41% of US market capitalization. In other words, almost half of the wealth available in the stock market was once generated by private markets.

What is in it for the investor?

It is encouraging to see Brazilian investors taking advantage of the potential and opportunities in the VC space and not only building a local ecosystem based on the successful examples and experiences

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[3] Professor of Finance at Stanford GSB, The David S. Lobel Professor of Private Equity. "The Economic Impact of Venture Capital: evidence from Public Companies".

in the US, but also investing in offshore VCs to profit from risk factor diversification. These investments foster innovation and new technologies, created locally or imported, that will help the country advance and grow. And it's important to emphasize: this movement is not an accident. It is part of a structural change that is here to stay. Investing in VCs can and should be part of a successful asset allocation model that aims to provide sustainable long-term investment returns.

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