FEASIBILITY STUDY

VENTURE CAPITAL IN PERU

Prepared for the United States

Agency for International Development

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by

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I. INTRODUCTION

A. Background/Proposal

> ...There is an important need for an institutional source of risk capital in Peru, particularly by medium-scale enterprises (MSE), and for professional skills to evaluate business opportunities and provide managerial and financial advice to companies during their formation stages...
>
> ...(Such a) company can...make a valuable contribution to the development of private sector enterprises in Peru by identifying promising business opportunities and bringing together local entrepreneurs, technical partners and the capital needed to develop those opportunities...

These preliminary perceptions of the possible goals and objectives for a venture capital fund to be established in the Republic of Peru were summarized by Faustino Garza of the International Finance Corporation ("IFC") in an internal memorandum dated January 27, 1982. In the memo, he elaborated more fully on the ways in which a venture fund might contribute to private sector development, through job creation, economic diversification, technological adaptations and innovations, and expansion of the country's entrepreneurial base.

A subsequent pre-feasibility study dated May, 1982, established more detailed parameters for such a venture capital fund. Specifically, it proposed that a fund be formed, capitalized at $5 million to $10 million, to take equity positions, generally minority positions, in entrepreneurial enterprises in Peru, whether these be start-ups, expansions of existing companies, or turnaround situations. Average size investment for the fund is proposed in the $200,000 to $400,000 range, though larger investments could be put together with participations -- equity or debt -- from other individuals and institutions. Control of the fund is proposed to be in the hands of the fund's private investors, though state development agencies and banks are proposed as participants in the fund's capital structure as well. Specifically, the Corporacion Financiera de Desarrollo ("COFIDE"), the Banco Continental, and several private investors expressed interest in participating in the proposed venture capital fund at that time.

Higher than average return to investment is established as the overall objective for the proposed fund.

General prospects for securing such returns are discussed. The pre-feasibility study provides an overview in macro-economic terms, of the recent economic history of Peru, of the conditions which prevail in the principal sectors of the country's economy, and illustrative current returns available in those sectors. This information serves to suggest areas of potential investment opportunity for the fund, particularly as Peru's present government begins to shift the country's policy framework toward more efficient capital resource allocation within the private sector. Whether or not such areas of general opportunities can be converted to actual opportunities for a venture fund will be a function of several specific factors present in the Peruvian market as discussed herein.

B. Assignment

Against this substantial background of 1) a concrete proposal for a venture capital fund, and 2) a general assessment of the economic environment within which it would operate, Daniel Tessler and Patricia Cloherty were retained as consultants by the United States Agency for International Development ("USAID") to narrow and deepen the review and analysis of the proposed venture capital operation, with specific reference a) to the capital market conditions that exist for venture investing; and b) to the underlying business opportunities available for achieving the proposed investment objectives. Under a), as outlined in Order #OTR-0001-0-00-2223-00, Mr. Tessler was to address the structure of the Peruvian capital markets; kinds of financial instruments; securities valuation methods used; and prospects for liquifying investments. Under b), as outlined in Order #OTR-0001-0-00-2224-00, Ms. Cloherty was to develop a profile of existing equity investment opportunities by type and level of risk, taking into consideration such factors as availability of management skills, prospects for broadened ownership of enterprises, and the legal and regulatory environment.

Based on both of these assessments, the consultants were to develop, as appropriate, recommendations for a suitable investment structure and strategy, with accompanying indicative financial projections.

Because each consultant focussed on a separate aspect of the same problem, we are submitting this report jointly. Section III assesses the opportunity, including relevant Peruvian capital market considerations, pursuant to Mr. Tessler's work agenda, and the business and economic environment for venture investing, pursuant to that of Ms. Cloherty. Section IV synthesizes findings in both areas into a series of conclusions and strategic recommendations.

C. Methodology.

Each consultant reviewed relevant background information on the Peruvian economy and financial conditions, then spent six days in Peru on a joint mission, accompanied by Mr. Garza of the IFC. Interviews were conducted with potential private and public sector investors; with representatives of relevant government agencies, educational institutions, and commercial banks; and with selected owners/operators of enterprises, which individuals had not been involved with the proposal to date. Appendix I lists reference sources consulted in the course of the work.

D. Purpose of Memorandum.

This memorandum summarizes our main observations, conclusions and recommendations. Additionally, in order to establish the context within which our judgments were made, Section II discusses venture capital investing and the elements that tend to be critical to its success in the

United States. In varying degrees, as noted, these same elements will influence the success, or lack thereof, of any venture fund established in the Peruvian environment.

It should be noted that this report is not intended as a broad, systematic overview of the structure and function of the Peruvian economy and financial markets. Rather, in a limited amount of time, the narrow practical aspects of equity investing were assessed, principally from the standpoint of practitioners. With the also narrow objectives of proposing how, if at all, such a venture fund might operate.

II. DISCUSSION OF VENTURE CAPITAL INVESTING

Our assessment necessarily reflects implicit comparisons with the present environment and practices of risk or "venture capital" investment in the United States. While direct comparison is not appropriate, some background on the origins of the business, its defining characteristics, premises and practice may be helpful in establishing perspective.

A. Background.

Venture capital investment began to be institutionalized as a specialized form of investment in the United States in the late 1940s. Prior to that time, venture investments were almost exclusively made by wealthy private investors, generally those associated with family interests controlling large corporate resources.

Institutionalization of venture investing under professional management dates from the Post World War II period. American Research and Development ("ARD") was formed in that period and established the precedent for others. Formed as a pool of capital from among wealthy investors in the Boston, Massachusetts, area, each of whom invested a small proportion of his total wealth, ARD was established on an area economic development premise. That is, given the decline of old industries in the area, the concept was that a capital pool which would make investment capital available could provide an incentive to attract new technologies, managed in the hands of skilled manager, to the area.

An early though small investment of ARD was in a start-up company, Digital Equipment Corporation. It has become the major manufacturer of minicomputers and one of the largest and most dynamic companies in the world.

Given that highly successful example, other pools of professionally-managed risk capital began to be formed, with capital provided until the mid-1970s principally by wealthy individuals. Increasingly, the purpose was financial gain rather than regional economic development.

Institutions, mainly financial ones, entered the field in the 1970s, substantially increasing the amount of total capital available for venture investments. So, in addition to private family interests, sources of such funds presently include also financial institutions such as life insurance companies, employee pension trusts, university endowments and major banks, as well as several major industrial corporations. Of these sources, only banks manage their venture funds directly through wholly-owned subsidiaries. Others generally select outside management companies to manage the funds for them, usually from among the established venture management companies. Capital made available for venture investment by such institutions represents a small portion of their total assets. It is intended to offset the inflationary drag on the fixed-coupon bonds and mortgages, and on stocks of slowly growing major companies, which comprise the bulk of their traditional portfolios.

Approximately U.S. $4 billion was estimated in 1980 to be under management of several hundred firms specializing in high risk investment, a four-fold increase over the total estimated for 1970.

The amount of capital is small in relation to aggregate U.S. capital markets. But it is considered unusually productive, socially as well as economically, because smaller companies in the venture category are known to generate both attractive employment and capital growth opportunities at much higher rates per unit of investment than mature companies are able to do.

Venture investments in general are long term, entirely illiquid for the first year or longer, pay no significant interest or dividends for several years, and are expensive to manage. They present a high risk of substantial loss and very high risk of failing to meet initial expectations without requiring more capital and artfully surviving unforseen crises. Despite these unattractive characteristics, perhaps because of them, good venture opportunities are hard to find, sought avidly by venture pools, and, like any other investment vehicle, sometimes become steeply overpriced.

B. Return on Investment.

To be financeable in the U.S., a proposed venture must credibly promise a minimum pre-tax return of 35%, compounded annually, and realizable within a 3 to 5 year holding period. This requires a return of 2.5 times investment in 3 years, or 4.5 times in 5 years, assuming no interim dividends or interest are paid. The minimum target return varies from portfolio to portfolio, of course, but the minimum target for each investment must exceed the minimum target for the portfolio as a whole, in order to allow for operating expenses and losses.

It also varies with fluctuations in yields available from alternative investments. At the time of our visit to Lima, for example, liquid U.S. government debt securities of 3 to 5 year maturities offered a 13% annual yield, or 6% to 7% "real returns before taxes. A venture portfolio yielding a 30% average return, therefore, would produce approximately 3.6 times the real yield obtainable without the risk, expense, and work of a venture investment portfolio.

Return means just that, an amount received by the original investor in cash or liquid securities upon sale of the investment to others. Divestment strategy is considered (and agreed at least informally with other parties) at the time the investment is made. A credible divestment opportunity must exist if the investment is to be made at all.

Divestments in the U.S. are aided immeasurably by the existence of a broad, deep public securities market for minority holdings, and by an active corporate acquisition market for 100% buyouts. Both markets value investments in younger companies by capitalizing current earnings (not dividends and not formal net asset values) at a rate which reflects expectations for future growth of earnings and net cash generation. Such markets and valuation bases are critical to high rate of return expectations, as shown by the following example:

> Assume that $100 acquires a preferred liquidation position and half the residual value of a successful venture which earns $20, $40, $60, $80, and $100 in its first through fifth years, respectively, but pays no dividends.
>
> The investor will receive $650 and earn a 45% compound annual yield if the investment is sold after the fifth year at 12 times net income, which would be equal to 3 times net book value (the balance sheet value of assets Less liabilities). These are at least "normal," and quite possibly low, capitalization rates for a U.S. venture with this record.
>
> However, if the sale is made at net book value (equal to 4 times net income) the investor will receive $250 and a yield of only 20%.

Even the addition of a 15% current annual dividend would only increase the yield in the latter case to 28%, overall. It would be an unusual venture in any case which could pay such a dividend in early years and also finance its growth without diluting ownership values.

C. Target Opportunities.

Given the relative maturity of the U.S. economy, suitable venture investment opportunities in the United States tend to be early-stage (often startup) companies which have developed or propose to develop new products based upon advanced applications of technology. Frequently, this technology will have emerged fairly recently from the laboratory into commerce, and it usually is patentable or otherwise protectable in the market. Seasoned management is sought from successful, larger enterprises in related activities in order to reduce "people-risks." Several venture investors may be asked to support the initial investment. One, a "lead investor," generally carries the primary burden of monitoring the investment, usually through a seat on the Board of Directors as well as through monthly financial reports. Other investors share the overall risk, stand ready to provide additional capital if the venture remains promising but falls short of funds, and also may contribute industry-specific or technology-specific knowledge and contacts acquired through prior experience.

Technology-based venture investments are made at several stages of development, presumably at increasing values as earlier-stage risks are overcome and later-stage risks are assessed more easily.

Technology, market, and divestment risks are paramount in such well-conceived, properly staffed, and adequately financed ventures. Does the technology work? Can it be applied successfully to the commercial product contemplated? Can the product be manufactured economically? Will the market want it at the price at which it can be delivered? And, if everything else goes well, will the market be large, uncrowded, and profitable enough for long enough to permit the investment to be sold at a high value based upon future growth potential?

This last question remains a critical one. While successful technology-based ventures may earn unusually high gross profit margins, these profits must recover early development costs, fund sales growth, and sustain the continuing research and development expenditures needed to maintain competitive market positions over time. They are not available to pay dividends or retire shares.

The expansion of available venture funds, the intensive competition for technology-based investment opportunities, and the increasing sophistication required among investors to evaluate such opportunities have combined to broaden the variety of opportunities now considered appropriate venture vehicles. High return objectives remain, as does the premium placed upon seasoned management and attractive divestment opportunity, but the nature of risk changes. For example, in "leveraged buyouts" of large, established businesses, venture investors assume the financial risk of extreme leverage (liabilities up to ten times equity) in place of technology risk. High returns result less from business growth and creation of new economic value than from reduction of debt through cash flow and the resulting increase in the value of equity, even at the same overall asset value as was paid on acquisition.

Portfolios often reflect a spectrum of investment types. However, all but the very largest fund managers tend to specialize toward one end of the risk spectrum or the other, and often to specialize within specific industries, technologies, or markets.

D. Management/Compensation.

The "equalizer" that holds all parties to a venture investment to the same objectives is the stock participation of each, through which each party has the prospect for substantial future capital gain. In some instances, as in the case cited of Digital Equipment, the gain is sufficient to create sizeable fortunes at each level of the transaction.

Management of the venture enterprise invariably has an ownership interest in the enterprise. In fact, the stock interest of the key managers (generally a founding or acquiring "team") is viewed as a major element of their overall compensation, with their salaries often set well below the level they might command as non-participating employees elsewhere. Their central task, then, is to increase the value of the shares they own, which objective coincides with that of the venture management company as well as those of the passive capital sources.

Depending on several variables, operating management generally retains ownership -- apart from any capital they may invest -- ranging from 15% to 50%. This is ownership interest retained by management, not for its capital contribution on a pari passu basis with outside investors, but for its having created and developed, and for continuing to manage, the venture opportunity. The bulk of this ownership will go to one or two central figures, with the balance spread among three or four secondary members of the management team. Investments are often structured so that the management ownership becomes valuable in its own right only after all investor capital, plus a moderate annual return, is returned to investors.

However, the capital actually invested by management is usually treated in the same fashion as that secured from other investors. The amount is significant chiefly as a measure of management's commitment; $75,000 from an individual with no significant assets can count as much as $1 million from a multi-millionaire. Skill and commitment, not capital, are wanted from management.

The venture management company receives its compensation in two ways. First, it receives an annual fee equal to 2% to 5% of the total capital of the fund, intended to cover all staff, office, and other operating costs. In addition, however, a fund's management generally earns 15% to 20% of net gains realized from the investments. Again, the bulk generally goes to a limited number of central figures in the fund management and the balance is spread among two or three supporting professionals.

It is not common for venture fund managements to seek significant income by selling other services, although special additional work by a "lead" investor may be converted into a somewhat preferred or lower-cost investment position. Investors tend to view venture-related fee opportunities as the "property" of the fund, not of its managers. In any event, such activity easily can reduce effectiveness in the primary effort to find and, sometimes, to create venture opportunities, structure proper investment transactions, monitor subsequent performance, assist in solving investee problems as they arise, and find and negotiate divestment transactions when maximum return is available.

E. Structure/Timing

While venture managements may go on and on, pools of funds tend to be created with a strictly limited life, most often in partnership form, generally for 8 to 15 years. Several pools may be under the same management at the same time, either in series or with distinctly different areas of investment focus. Each pool has a liquidation date, however, which becomes a primary element to be considered in establishing its portfolio mix and strategy. Both must change as liquidation approaches.

United States legal and tax structures have evolved over time, and recently have improved in notable respects, to support venture investments. (A special study of these practices could be of benefit to policy makers in Peru, but the subject is too complex to treat here.) In general, however, risks are reduced by various mechanisms which permit tax reductions for investor losses and sometimes for the losses incurred in the early stages of a subsequently successful business. Capital gains -- as distinguished from salary, interest, dividend and other income -- are made relatively more attractive by taxation at reduced rates. And favorable tax treatment of stock incentives for employees assists in attracting and keeping entrepreneurial management in investee companies. Only minimal use is made of tax incentives to investors for investment in specific types of industry, geographic areas, or other characteristics favored by current public policy, although some such incentives are offered for businesses themselves.

F. Summary Note.

Salmon-farming has been described by a U.S. investor as the classical venture capital experience.

First, he said, we spent two cents apiece to produce, fertilize, and culture twenty million salmon eggs.

Second, we hatched, housed, and fed ten million little fry. It cost ten cents for each.

Third, for another thirty cents, we released five million fingerlings into the river and watched them swim off toward the sea.

Then we began our three-year wait, wondering whether a million of the little wet ones would remember to swim back to our nets with three dollars apiece in their bellies.

III. ASSESSMENT OF THE OPPORTUNITY

A. Summary Assessment

Peru does not present a venture capital opportunity which is attractive on a world scale, but this may well be a time of great relative opportunity for those whose interests already are established in and committed to Peru.

It is difficult in Peru to justify the illiquid, long-term commitments normally associated with venture investment elsewhere for the following principal reasons:

1. A small domestic market provides relatively few opportunities to develop entrepreneurial business which will grow rapidly for an extended period at an economic scale for capital intensive industry. Alternatively, as long as Peruvian workers are substantially more expensive and better protected than workers in other developing economies, there will be few realistic opportunities to achieve important penetration of non-traditional export markets or to compete effectively in unprotected, domestic markets for goods of low capital intensivity.

2. Current returns presently available from alternative investments can be quite high, either from liquid money market instruments which are relatively low in risk, or from reinvestment in the established businessés which the holders of capital now control.

3. Tax and other financial incentives disfavor the investment instruments which are most appropriate to venture investment.

4. Even successful ventures may be unsaleable at appreciated values in the absence of meaningful equity capital markets.

5. Private capital is concentrated within a small, closed group, which does not have a tradition of supporting (without dominating) new entrepreneurial newcomers with skills and energy but no capital and standing.

6. Entrepreneurial efforts -- the practice of launching your own independent business after gaining experience in an established concern -- are not common among experienced middle managers in Peruvian businesses.

We believe, however, that locally-adapted principles of venture investment can produce above average opportunities and returns virtually everywhere. In Peru, the current macro-economic difficulties and distortions are receiving sincere and considered attention from well-motivated government and progressive private leaders, though signs of economic recovery are slow to appear. Greater than normal values may now be available. Change may now receive a warmer than usual welcome. For these reasons, it may be time to proceed with a privately-controlled institution that features astute management, low running expenses, a highly-selective investment strategy, and a focus more on current return potential than on capital appreciation.

B. Background and Perspective

Peru is large in area (1.3 million square kilometers), but only about 5% is cultivated readily for food production. An estimated population of 19 million is young, 70% urban, and growing at a rate of 2.7% annually. Gross domestic product -- now approximately $16 billion -- has shown an erratic, long-term real growth rate of 2.5% annually since 1970, one of the lowest in Latin America. Real per capita income has declined steeply in recent years, to approximately $700. An estimated 55% of the 6 million-member labor force is unemployed and/or underemployed. Income distribution is highly skewed: approximately 60% of income goes to the highest-income 20% of the population, 3% to the lowest; and urban incomes average 3 to 4 times rural ones. Asset ownership is similarly concentrated, and the State is a major owner of production assets.

Peru has extensive natural wealth in its mineral and fish resources, and to a more limited extent, in its agricultural capacity. Mining activity generates half of foreign exchange on average and is the major contributor to savings, but it represents only 10% of domestic product. Manufacturing is the largest economic sector, representing approximately 25% of gross domestic product but only about 12% of employment. It is concentrated in import-substitution consumer goods, and other final products, and has been encouraged by unbalanced financial incentives to favor capital-intensive lines of activity. The public sector represents approximately 17% of gross consumption and approximately 30% of gross investment (including that in State-owned enterprises).

Peru has been in economic crisis almost continuously for at least 15 years. Recessionary cycles dominated the years 1966-1968, 1975-1978, and 1981 to date in a pattern common to export-dominated economies: foreign markets deteriorate, trade deficits yield current account deficits which are too large to finance, and internal deflation is required to restore external liquidity.

The severity of downturns seems to have increased with each recent cycle in Peru. The volatility of commodity markets has increased, of course, with greater percentage changes from peak to trough prices and physical volumes. But two other factors particularly affect Peru. First, declining food production has combined with unintegrated industrialization to make the domestic economy more import-dependent and therefore more painful to deflate. And second, there is some evidence that declining levels of investment in major export sectors have diminished physical capacity and price-competitiveness, rendering Peru relatively more vulnerable to any given level of decline in world commodity demands.

Despite a sustained advance in aggregate economic performance, even 1969-1974 was a period of true crisis. A nationalistic and interventionist military government, which had taken power in 1968, sought to transform the ownership, income distribution, and export focus of the Peruvian economy through extensive nationalization and expropriation of assets, trade and capital controls, and labor and land reforms. The effects were hidden for a while by expansive domestic policies and an explosion in world commodity demands and prices. But the historical recessionary pattern emerged again in 1975, and, with national bankruptcy again threatening thereafter, it soon was widely seen that the reforms had caused structural damage while failing to improve (or change) the fundamentals of the economy. Three examples follow.

1. Selective nationalization and the establishment of a State marketing monopoly allowed the State to control virtually all mineral development, production and sale. Physical exports declined 30% from 1970 to 1974, despite a 25% improvement in Peru's terms of trade and record commodity prices towards the end of the period.

2. Approximately one-third of the available agricultural land was expropriated from large holders and given to small farmers and cooperatives. Agricultural investment declined thereafter, per capita food production declined, and Peru now imports sugar, formerly a principal export crop.

3. Modern manufacturing industry was the central focus of development policy, the objectives being to deconcentrate ownership and promote economic and employment growth in a sector relatively autonomous of the international business cycle. By 1972, State- and socially-owned enterprise accounted for roughly half of employment and value-added in the reporting manufacturing sector, and similarly substantial proportions of total exports and banking assets. In effect, ownership concentration had increased dramatically, although aggregate foreign and private domestic ownership had declined. From 1971 to 1978, manufacturing

value-added was constant in real terms, while labor productivity in manufacturing declined 20%, real wages and salaries declined 50% by some measures, and Lima's unemployment and under-employment increased from 20% to 42% of the labor force.

Peru has begun to reorder its economy and to sort out the lessons of this long, painful experience. The process began in 1978, and has accelerated since the election in 1980 of the present government. Recent policy direction, in general, has been toward decontrol and reaffirmation of free market and private property principles. Domestic policies and steady short-term economic pressures have inhibited rapid adjustments, however, and the immediate effects of some adjustments, such as price and import decontrol, has been to exacerbate short-term difficulties. With inflation apparently embedded at a 70% rate, restoring equilibrium by freeing trade and interest rates may require widespread debt liquidation and asset reorganization. Major distortions and conflicts remain in internal prices, financial incentives, sectoral balances, and wage and employment policy. Capital remains lethargic and wary. And social unrest is emerging again into politics and sporadic violence. In short, quite apart from the uncertainties and financial stress of the present recession, little can be assumed as yet about the long-term investment climate within Peru.

C. Financial Markets and Investment

1. Government Role. Peru's financial markets are free in principle. In fact, they are dominated and closely managed by government.

The State is a major, direct participant in financial markets. The State and State-owned institutions hold 80% of all financial assets excluding equities and privately-contracted debt. State holdings include nearly half of commercial banking assets, which are the primary source of business credit and business-oriented ffnancial markets. Through specialized institutions, the State is nearly alone in providing the minimal amounts of medium- and long-term credit which are available from domestic sources. There is no institutional source of risk capital, State or private.

Through the Central Bank, the State manages broad monetary policy policy and actively (although indirectly) allocates credit. The Central Bank has the power to fix all interest rates for deposits and borrowings (and therefore to fix intermediaries' spreads as well). This power to fix interest rates and spreads is used to implement monetary policy, along with more traditional powers over fractional reserves, rediscounting, and foreign exchange. It is also used to allocate or "channel' available credit to favored classes of borrowers and activities by permitting more favorable terms in priority sectors.

More narrowly, of course, the government regulates all bank and financial system operations, commercial and corporate law, corporate chartering, securities trading, accounting methods and financial reporting, and similar elements of the markets.

2. Incentives. Like other countries, Peru over time has evolved a system of tax-based financial incentives which alter the relative rates of return that a free market might establish. Each incentive was intended to serve a particular policy objective at the time of its adoption, but there seem to be important conflicts among them now. It could be argued that, taken as a whole, the incentive system now discourages productive investment in Peru. We offer the following as observations, not judgments, as we are fully aware that the issues are complex and that our knowledge is incomplete.

a. Incentives tend to favor foreign-currency holdings over domestic holdings. The only real yields available in the money-markets are those from savings instruments denominated in foreign currency, particularly in U.S. dollars. This may be necessary to minimize capital export while avoiding exchange controls, but it severely depletes the total resources otherwise available for productive investment.

b. Incentives tend to favor lending over equity investments. Interest paid by financial institutions on deposits and other instruments is received tax-free, while dividends paid on share-holdings are taxable. One counter-incentive is intended to reduce this effect by deferring tax on dividends which are reinvested. But this neither assures productive use of reinvested capital nor encourages fresh investment at the equity level. Ironically, another counter-incentive is the high rate of inflation and negative yields on sol-denominated savings.

c. Incentives tend to favor short-term over medium- and long-term investment. By law, banks lend for a year or less, and are substantially free from income tax. Financieras lend for more than a year, and are subject to income tax. Other things being equal, lenders are penalized for supporting capacity increases, which typically lead markets and require time to come on stream, as opposed to supporting working capital increases, which tend to be opportunistic and market-led. A counter-incentive permits financieras to pay slightly higher rates for long-term deposits than banks can pay for short-term deposits, but banks are allowed to compete for the long-term deposits at the higher rates. And the spreads permitted to financieras recently have been narrower than those allowed the banks.

d. Incentives favor the services over the productive enterprises they serve. The industrial and mining sectors which create the bulk of the value in Peru's economy are subject to income taxation (and other substantial taxation in the case of mining) as well as a mandatory distribution to employees of 25% of profit and up to 33% of the outstanding ownership. Recently, this was reduced by law to a 17% cash distribution. Banks are largely free of tax, as noted, and most service businesses, including distributors and financial services, are free of the costs of labor participation. Other things being equal, therefore, the service businesses tend to be more secure and more profitable than those which take the risks of fixed investment to produce for uncertain markets.

e. Incentives favor capital-intensivity over labor-intensivity, as a result of high minimum wages and payroll taxes, rigid rules for worker tenure, and negative real costs of capital. This is neither good nor bad in itself, but it has encouraged the unbalanced development of industry and at least in part explains the pronounced underutilization of labor. A counter-incentive to grant tax benefits for labor-intensive investment activity may be useful politically, but it seems only marginally relevant to the underlying economic issue.

3. Investment Patterns and Structures. Private fixed investment has declined substantially and steadily for an extended period. It represented 17.5% of gross domestic product in the mid-1950s, but declined to 10.8% in the mid-1960s and 6.5% in the mid-1970s. The trend may have stabilized and reversed slightly in response to the recent stabilization of public policy, but the decline started long before the period of radical reforms began. It persisted during the sustained economic upswing of 1970-1974, and throughout the 1970s, despite high operating profitability in most businesses, subsidized capital costs, and extraordinary protection of domestic markets. It should not be assumed, therefore, that low levels of investment have resulted principally from political upset, periodically depressed business conditions, poor return potentials, or scarcity of capital.

Only the banking system is institutionally organized to mobilize savings for investment. There are minor exceptions to this generality, to the extent that public investment is financed through tax receipts, direct placement of government debt, and borrowing of the social security trust funds (which are tax-based in any event). But there is no significant accumulation of capital in formal life insurance or pension reserves, mutual funds or similar institutions. There is no organized source of equity capital, public or private, although a small casualty insurance sector does invest a portion of reserves in minority stock positions in well-established operating companies.

Investment is financed principally by direct borrowing from the banking system and affiliated intermediaries, and, at the equity level, by self-financing or direct placement with foreign sources or an informal network of private investors. Debt-to-equity ratios can be high by U.S. standards, two-to-one being common for younger firms. But debt tends to be fully secured by assets and/or personal guarantees, rather than non-recourse or unsecured.

Equity capital is rarely available outside family groups and their affiliated companies. The major groups are organized around the majority ownership of one or more successful operating companies which are actively managed by a member of the ownership group. The bulk of earnings are reinvested, to minimize individual taxes. Individuals receive directly only moderate current income in the form of salary and cash dividends. Existing business is expanded, usually slowly and in closely related lines, as the company's liquidity and opportunity allow. Excess company capital may be retained in liquid holdings or used to diversify holdings by purchase of minority interests in expansions of other companies under the control of like-minded groups. Relatively little debt is used to finance the ongoing operations or the expansions of the established groups, although they have substantial borrowing power and possible substantial advantages in borrowing more heavily in an inflationary environment. Only rarely is ownership diluted by the sale of stock to outsiders. Instead, the rate of growth and the amount of unused borrowing power are controlled carefully to avoid the need for more capital than is available internally.

In this fashion, the bulk of capital which is not mobilized for lending by the banking system is generated, retained, and invested in, through, and for the benefit of the existing ownership interests. The balance of the capital generated in this sector is in the hands of the individual members of the control groups. After meeting personal needs, they tend to seek short-term, low-risk investments, frequently abroad, or personal and investment real estate. In all, it is a conservative and in many respects an efficient system. But, in terms of the premises of the proposed fund, the system is closed to the entrepreneurial competition which has sometimes fostered dynamic growth in otherwise static economies.

The mechanical structures already in place are quite adequate to support broader and deeper capital markets. Skilled personnel and professionals are in good supply. The legal and accounting codes are comprehensive and fairly flexible, although additional protections for minority stockholders could be helpful. With normal investment and scale-up time, the markets could process readily increased volumes. If demand should emerge, the markets probably would rapidly introduce more sophisticated instruments and techniques, and the legal and accounting systems would evolve to accommodate.

Under current circumstances, only the banking system is highly developed. It concentrates on deposit accounts, the extension of short-term commercial and industrial credit, the provision of financial services and trade financing on a fee basis. Such credit, as noted, generally is secured by pledges of substantially all of the borrower's assets and/or by the guarantees and specific assets of the principal owners. Bank-affiliated financieras to a small but growing extent are taking long-term deposits (1 to 3 years) and extending commercial credit for similar periods. There is little or no banking system activity in longer-medium or long-term commercial finance, whether asset-based or unsecured.

The dominance of the credit institutions in the Peruvian capital markets is shown graphically in Appendix II. While legal supervision of this structure has been realigned under the present administration, its makeup and functions remain essentially unchanged.

The Lima Stock Exchange is the seat of an open auction market for publicly-held debt issues and shares. It is a century old, and is now organized along modern lines. Again, the mechanics are reasonably established and could accommodate much growth, but the actual markets are still narrow and shallow. Only a few debt issues of the State (or its agencies) are traded with any regularity. Approximately 1,000 private companies in Peru have revenues of $1.5 million or more, but only 39 voluntarily list their common stocks. About 100 issues are listed in all, including banks and others required by law, and listings which are limited to the labor participation shares issued under legal compulsion (and significantly less highly valued than the ordinary common shares). Ten or fewer parties hold more than 50% of all listed companies. The principal holders are often members of the same family. The latest data available indicate that in no issue was more than 10% of the outstanding shares traded in 1980, and only a few experienced 5% turnover. The public market has been used by only one company since 1978 to aggregate capital -- a real estate development company. The initial issue was successful and led to a second successful issue by the same company but the practice has not spread.

The public markets are so thin that valuations are not meaningful, except perhaps as measures of change or relative valuations among firms. Speculative influences prevail. The index of 15 leading companies, for example, increased 900% from 1975 to 1980, then declined 80% in fifteen months. In the same period, the value of trading increased 1,200% before falling 80%. The period of increase was marked, first, by the closing of other money channels: land markets were unattractive as expropriations proceeded and mortgage financing was prohibited; imports of consumer goods were restricted; negative interest rates prevailed in sol-denominated instruments while foreign exchange rules reduced the usual levels of capital export. And then, after 1978, a second explosion in world commodity prices triggered renewed speculation, especially in mining shares. This extended the speculative boom in shares, despite the easing of foreign exchange restrictions and reversals of most of the original restrictions which brought money into the stock market. Share prices collapsed as soon as commodity prices peaked.

What is most interesting about the period is that a rise in quoted prices had virtually no effect upon the controlling interests' attitude toward the public markets. Spectacular increases in "market value" brought forward no additional supply of shares, although prices at the peak represented six times the accounting book value of the shares and an estimated 30 years of reported net earnings.

4. Returns. Venture investments are measured financially against the current returns otherwise available with low risk and the total returns, including appreciation, otherwise available from the risk securities of more established firms. Venture capital often sacrifices much of the former in hopes of doubling or tripling the latter.

Real, after-tax current yields of 6% to 10% were available to Peruvian investors in mid-1982 from liquid instruments with no practical risk to relatively little risk. And similar yields could be "locked in" for ten years or more. Peruvians investing abroad, for example, could purchase U.S. Treasury obligations offering 12% to 15% nominal current yields for maturities of three months to twenty-five years, or 6% to 9% in real terms after the dollar's rate of inflation. Domestically, sol-denominated instruments offered approximately 5% negative yields after the widely-believed (but unofficial) 70% rate of inflation. The dollar-denominated instruments, however, yielded 9% to 10% currently (real) and embodied the least credit and political risk of any Peruvian securities. Short-term bank certificates of (dollar) deposit yielded a nominal 15% at one-half percentage point below the London Interbank Offered Rate. They represented nearly 50 % of all commercial bank deposits. The ten-year Tipo C Bonds of COFIDE, guaranteed by the State and also denominated in dollars, sold at 70% of their principal amount to yield a nominal 16% currently and 18% to maturity.

Equity returns are much more difficult to establish, of course. We estimate that 20% to 25% net annual returns on equity, substantially in real terms, are realized over the normal business cycle by the better-established industrial and financial service business, such as those controlled and largely owned by the most likely venture capital investors. Returns in mining industry can be vastly higher in strong years, and for the well-established mines may average 25% to 35% over the normal cycle.

Dividends paid out average about 20% of earnings. They provide an average 7% current yield on average equity (at theoretical replacement cost) but a much higher real return on actual investment at historical cost. There is relatively little incentive to pay dividends, since they are taxable and because reinvestment generates tax credits. Controlling shareholders may realize significant but uncountable cash flow benefits in addition to dividends.

Estimates are based upon our analysis of the 1978, 1979, and 1980 financial reports of the 61 mining, industrial, and financial service firms whose shares were listed in all three years. As a group, they reflect the operations of Peru's leading private interests, although many of the major companies are not included. The period is reasonably reflective also: it moved from a recessionary low (1978) through rapid recovery (1979), then more slowly to and perhaps slightly past the latest cyclical peak (1980). Data are summarized in the tables on pages 34a, b, c, and d.

Performance seems to have been satisfactory in all sectors. Mining enjoyed two years of record prices and extraordinary profitability. Industrials employed previously idle capacity and improved margins more rapidly than sales. And financial firms reported high percentage earnings gains, but apparently were recovering from an especially depressed base. (Total assets of financial firms declined 10% in real terms in 1979 while earnings increased 25%, suggesting that much of the 1978 asset base was unprofitably employed).

Over the two-year period 1978-1980, all sectors grew in real terms in addition to offsetting a 64% compound annual inflation rate. Real net sales of industrial and mining firms, respectively, grew 9% and 29.

annually, while total assets of financial firms grew at 6% per year (down 10% in 1979, up 19% in 1980).

Operating margins in industry and mining reached 30% of net sales in 1979 and 1980, in large measure due to the high prices being realized in mining. However, at an average 17.5% of sales, the operating profits of industry alone were high by most measures. Assuming a 40% average charge for worker participation and income taxes paid, these operating margins would produce net income at 11% of sales, excluding non-operating income and expense, enough for a 20% to 25% net return on the estimated equity in operating assets.

Net income as reported in 1979 and 1980 represented an actual 29% annual return on the average equity of all 61 firms. Mining returns led the rest at rates in the mid-40s, while industrial and finance returns were recorded in the low- to mid-20s. Even allowing for the satisfactory business environment, these levels of return are high by international standards, especially so when considering the factors noted below.

a. Returns are not enhanced by leverage. All sectors employed conservative capital structures. Industrials and mining financed 84% of their invested capital with equity, the balance about equally with long-term debt and unfunded retirement reserves. Banks, which represented two-thirds of the finance sector's assets, maintained a 4.6% equity/asset ratio.

b. Returns are more-or-less real, because Peruvian accounting theoretically reflects the replacement cost of assets. Realty and invest-

LISTED FIRMS, SELECTED DATA

(Billions of Current Soles)

	Note	24 Industrials	13 Mining	Industrial & Mining	24 Finance	All Firms
Year-end Assets	1					
1978		80.5	32.0	112.5	379.3	491.8
1979		139.8	72.9	212.7	567.6	780.3
1980		237.2	117.8	355.0	1,140.0	1,495.0
Average Assets	2					
1979		110.2	52.5	162.7	473.5	636.2
1980		188.5	95.4	283.9	853.8	1,137.7
Year-end Invested Capital	3					
1978		51.7	24.1	75.8	NA	NA
1979		100.3	50.8	151.1		
1980		171.0	83.4	254.4		
Average Invested Capital	2					
1979		76.0	37.5	113.5	NA	NA
1980		135.7	67.1	202.8		
Year-end Equity	4					
1978		45.7	20.5	66.2	22.8	89.0
1979		82.6	43.1	125.7	42.2	167.9
1980		138.8	72.5	211.3	81.1	292.4
Average Equity	2					
1979		64.2	31.8	96.0	32.5	128.5
1980		110.7	57.8	168.5	61.7	230.2
Net Sales	5					
1978		58.9	24.4	83.3	NA	NA
1979		108.7	66.5	175.2		
1980		186.5	109.6	296.1		

	Note	24 Industrials	13 Mining	Industrial & Mining	24 Finance	All Firms
Operating Profit	6					
1978		8.9	9.3	18.2	NA	NA
1979		17.4	34.4	51.8		
1980		36.0	51.8	87.8		
Net Income	7					
1978		6.4	4.6	11.0	3.1	14.1
1979		15.1	15.3	30.4	6.7	37.1
1980		23.3	26.0	49.3	16.3	65.6
Dividends						
1978		1.2	1.1	2.3	.8	3.1
1979		2.3	3.8	6.1	1.4	7.5
1980		4.5	10.2	14.7	2.2	16.9

NOTES:

1. Net of depreciation reserves
2. Total of successive year-ends divided by 2
3. Total assets less current liabilities
4. Patrimonio, includes revaluation surplus
5. Excluding severance and excise taxes
6. After interest; before investment income, other non-operating income and expense, worker profit participation and income taxes.
7. As reported, excluding revaluation of assets

NA Not Applicable measure of finance firms

LISTED FIRMS, SELECTED DATA

(Percentage Ratios)

	24 Industrials	13 Mining	Industrials and Mining	24 Finance	All Firms
Annual Real Growth Rate (1978-1980)					
Net Sales	9	29	15	NA	NA
Operating Profit	23	44	34	NA	NA
Net Income	16	45	29	40	32
Invested Capital	11	13	12	NA	NA
Equity	6	15	9	15	11
Dividends	18	86	54	1	42
Sales/Average Invested Capital					
1979	143	177	154	NA	NA
1980	137	163	146	NA	NA
Average Equity/ Average Invested Capital					
1979	84	85	85	NA	NA
1980	82	86	83	NA	NA
Operating Profit/Net Sales					
1978	15	38	22	NA	NA
1979	16	52	30	NA	NA
1980	19	47	30	NA	NA
Operating Profit/ Average Invested Capital					
1979	23	92	46	NA	NA
1980	27	77	43	NA	NA
Net Income/Net Sales					
1978	11	19	13	NA	NA
1979	14	23	17	NA	NA
1980	13	24	17	NA	NA

	24 Industrials	13 Mining	Industrials and Mining	24 Finance	All Firms
Net Income/Average Equity					
1979	24	48	32	21	29
1980	21	45	29	26	29
Dividends/Net Income					
1978	19	24	21	25	22
1979	16	25	20	20	20
1980	20	39	30	13	24

ments are carried at historical cost, but all other non-current assets are revalued annually to reflect inflation in replacement costs. The surplus over historical cost is capitalized, then taxed and depreciated in subsequent years. The surplus is not taken into income. Reported net income and book equity, therefore, theoretically relate to the same moment in time.

In practice, the rate of return is misstated in real terms to the extent of these factors: first, increases in rate of return which could be attributed to a deflation in the value of debts and liability reserves; second, decreases in rate of return which could be attributed to an inflation in the value of realty and investments carried at historical cost; and third, increases or decreases which could be attributed to miscalculation of the revaluation surplus. The first point is not significant, because the companies do not employ much debt. The second point may be quite significant because a large portion of liquidity is invested in realty and non-operating investments which produce substantial income. As to the last, the taxable nature of revaluation surplus suggests that it is more likely to be understated than overstated, which would tend to undervalue assets in real terms and therefore would overstate the implied rate of return. On balance, the last two factors are thought to neutralize each other.

IV. SPECIFIC OBSERVATIONS

A. Critical Conclusions.

Our observations of the Peruvian economy, capital markets and business environment presented in the previous section led to several conclusions, on which our recommendations as to future strategies, policies, and procedures are based, as follows:

1. The original premise that there is no institutional source of equity -- or venture -- capital in Peru for financing growing small- to medium-sized businesses was verified.

2. There is no lack of private capital for investments. On the contrary, capital appears to have been abundant and cheap for an extended period of time. Such private capital as is employed in productive enterprises generally is employed highly efficiently by skilled owners/managers. In the aggregate, however, such local private investment appears both to have been declining and to have become more concentrated in recent years.

3. A clear picture of potentially substantial venture investment opportunities that might be exploited but for lack of available capital did not emerge. Current owners of commercial and industrial enterprises are aware of opportunities, which they pursue individually and in groups within a narrow range. They bring capital, management, vision and often, a market to these undertakings. Though there may be compelling reasons for them to step outside this pattern and back new entrepreneurs, these reasons are more philosophical than economic, at least in the short run,

and will entail some additional risk.

4. <u>Therefore, the basic premise that availability of a capital pool, by itself, will serve to overcome barriers and unleash a storehouse of entrepreneurial energies was not proved</u>. Nor, we should add, was it disproved, since there appear to be a sufficient number of highly-skilled Peruvian managers who might choose to undertake their own businesses, a) were such capital available; b) together with professional backing in organizing and operating the business; and c) especially given the introduction of policies and instruments that begin to favor such risk-taking, rather than to throttle it. To date in the country, such entrepreneurial risk-taking, other than in the informal sector on a very small scale, has been rare. That which has existed will have to be built on.

B. <u>Principal Rationale for Fund</u>.

We were unable to develop a prospective portfolio profile pegged to identifiable venture opportunities capable of yielding the required returns, and of justifying private investments in the fund in straight economic terms.

Rather, the principal rationale for the formation of the fund (comparable to the ARD example cited in Section II) must be that it is both necessary and good for the country. And, given a pooling of nominal amounts of capital from knowledgeable sources, it can be mounted and run in a manner which minimizes risk for any one party.

The necessity arises from the economy's general pattern of long-term decline and its current fragility which owes, in part, though certainly not exclusively, to private resource concentration. The "good," or potential benefits, arise from the fact that beginning to open capital in this manner increases prospects for rejuvenating the economy, while at the same time preserving existing interests accompanied by broader distribution of benefits. The methodology of the fund is highly selective: it can take only a handful of locally-based, high-growth companies to introduce vitality into an economy, and to establish freer capital flows. In our view, of all alternatives, the fund concept offers possibly the least-risk means of beginning to rechannel and expand private business energies without continued extensive public sector intervention. If it is effective, all parties at interest benefit -- investors, entrepreurs, and employees.

Owners enjoy handsome returns on capital in Peru. And they closely guard their prerogatives. The fund offers a sophisticated means of attracting the "best and the brightest" of younger Peruvian managers to the task of creating new economic value in an organized, non-confiscatory manner. Because it goes against both trends and traditions in important ways, however, it will have to be mounted carefully, with clear goals and able people running it. Our suggestions in that connection are discussed below.

C. Recommendations.

For convenience, we have christened the proposed fund "Newfund" in this section. In it, we have attempted to provide fairly detailed recommendations as to operating goals, policies and procedures for Newfund. This falls far short of good quantitative analysis, however. For, as indicated, we were unable other than in a general way to pinpoint specific historical models and targets of opportunity on which return projections might be based.

1. <u>Goals and Objectives</u>.

Newfund will be unique in the Peruvian capital market environment. In pursuing private profit objectives, it will be seeking coincidentally the goals that have proved elusive, not only in Peru, for public policy to achieve, namely, capital formation and job creation.

Its goals and objectives, therefore, should be set forth clearly and specifically in order to distinguish its offerings from those of other financial institutions, but more important, so that it secures the transaction base required to justify its existence.

- <u>Overall Objectives</u> -

We would recommend that consideration be given to adopting the following general goals:

a. To operate as a privately-controlled venture capital fund;

b. To assemble a pool of risk capital and the internal management capacity necessary to invest and manage such capital

c. To provide medium- and longer-term capital, through equity and equity-type investments, frequently in minority positions in businesses, principally those with above average potential for growth.

d. To achieve an overall real return on capital in excess of the prevailing level of real return on equity available in established businesses.

Newfund also should establish a narrower series of objectives which give operating direction to the fund and are adapted to Peru's specific requirements, such as the following:

a. To broaden the economic base of Peru by assisting in the formation or expansion of entrepreneurial enterprise;

b. To promote private independent entrepreneurship;

c. To introduce concepts and techniques for expanded ownership of business and industry based on individual merit;

d. To train a corps of skilled risk capital managers;

e. To develop and adapt techniques and investment intruments for risk capital management;

f. To forge an institutional role for placement of risk capital in relationship to that provided by existing institutions.

Aside from shareholder returns, the most important fundamental effect of Newfund over time may be to establish the concept of the entrepreneurial management team so central to U.S. venture investment. As capital has not typically been available to talented persons without capital reserves of their own, it takes a long time to build an entrepreneurial enterprise to a size at which its returns justify the long hours, economic insecurity, and personal strains imposed by a small, independent business. If Newfund offers a new approach, it may find a sizable number of well-trained, creative individuals now working for others who will relish the entrepreneurial challenge when ownership is coupled with access to enough capital to pursue business opportunities, particularly those they believe may be substantial. Since such an offer would be rare, if not unique, Newfund should have its pick of the best people and the best plans, and should not be pressed by competition from other investors to overprice the better opportunities.

2. Return Objectives. The overall return objectives of Newfund should justify the shareholders' investment in straight economic terms. It should therefore be seen as a superior alternative among those which are available to the shareholders. As discussed earlier, these included:

a. 10% real, current, cash, after-tax return on relatively low-risk, liquid money-market instruments; and

b. estimated 25% real return on average equity in established business, about 7% paid currently and taxable, the balance reinvested and eventually realizable tax-free on sale or transfer to successors. Given the concentrated and long-term nature of ownership, one expects that shareholders view their return rate to be the full return to the corporation, rather than the dividends paid.

A significantly higher rate should be sought by Newfund to reflect its nature as a risk investor in illiquid positions without the intention to exercise control. As a practical matter, it will not be possible to compete with alternative market returns if Newfund cannot receive interest, at a minimum, and preferably both interest and dividends on a tax-free basis. We assume that the law has been changed to permit company interest to be received tax free.

We recommend an overall target rate of at least 30% per annum, in real terms. A higher target could easily be justified, but in some respects Newfund would be ahead of its time in Peru. Its ability to realize the extraordinary level of return which would be proper in theory will depend in practice upon the rate at which capital markets follow its lead.

The minimum current return should equal the costs of management, say 3% of total capital, plus perhaps one-third of the real money-market rate of interest, or 6% in all. The remainder of the overall return should be realized in two parts: increased current payouts as each portfolio company grows, and capital gains on sale of each investment position to management, an acquiring company, or public markets.

The proportions of overall return from each element would vary with the specifics of each investment. Some would produce early, high current returns with relatively little prospect of capital gain; others the reverse. In composite, a "typical" investment pattern might look this.

	Cumulative (Investment) Return	Returns Of and On Investment: Current	Returns Of and On Investment: Capital
Start	(100.0)		
Year 1	6.5	6.5	
2	6.5	6.5	
3	49.5	19.5	30.0
4	62.6	17.6	45.0
5	74.6	14.6	60.0
6	85.7	10.7	75.0
7	95.9	5.9	90.0
End	281.3	81.3	300.0

The internal rate of return is 31.8%, compounded annually, on the initial investment of 100. The portions noted as "current" end "capital" represent 11.5% and 20.3% return rates, respectively. The life of the investment is assumed to be seven years, starting with a current minimum annual yield of 6.5% and an ownership feature which justifies the undertaking. At the end of year two; it is assumed that management (or the company itself) agrees to purchase the investment position at the negotiated price of 300, providing a gain of 200%. The purchase price is payable in five successive annual installments of 10%, 15%, 20%, and 30%, and the unpaid balance bears interest at 6.5% per annum. The annual cash requirements increase throughout the buyout period, presumably remaining consistent with the company's internal cash flow or external financing capabilities.

3. <u>Investment Strategy and Opportunities</u>.

Newfund's investment strategy has to be developed around opportunities that will permit it to achieve the overall return objectives discussed above.

The simplest strategy would allocate substantial capital, up to one-half the portfolio, to the production of safe current returns with the balance to be invested in ventures with prospects for very high capital gains. In our view, this is not a reasonable investment strategy for Newfund, since it would not be likely to result in the creation of substantial new economic value, nor would it have much impact on broadening entrepreneurial ownership, both of these being primary objectives of the fund. Finally, it would weight the portfolio toward a low return which would not be likely to justify the costs of operations.

Newfund will have a high overall return objective based on both current average cash return and capital gain potential based mainly on pre-negotiated management buyouts. Therefore we recommend an alternative strategy which would place a premium on risk investments in a) early-stage growth businesses; and b) businesses which, if successful, will throw off substantial cash relative to the capital investment required; and c) the minimum amount of total capital (in a fully-invested portfolio) placed in passive, secure instruments to cover operating expenses.

Among the candidates are established businesses with moderate to high growth potential which require a capital infusion for expansion or consolidation. Newfund generally would consider investments in those firms which have seasoned management either in the company or prepared to take it over and which have established products and markets. But it should focus on those having realistic growth opportunity through geographical expansion of markets; expansion of product lines; and improved production efficiencies as a result of the introduction of alternative techniques or technologies. Those particularly advantaged with large market scope combined with one or more competitive advantage (market dominance, low factor cost) will be especially attractive. In general, the better-established the business, the more able it will be to support a higher current charge for capital, and the less likely to sustain rapid growth and produce large capital gains. Also, the more established firms are less likely to permit liquidation of Newfund's interest by sale to a major firm.

Start-up and early-stage ventures are riskier and generally less apt to support high current capital charges in their early years of operation. These usually are the source of the highest level of capital gain potential for venture funds in the U.S., and they usually are based on proprietary technology requiring years of development and, from an investment standpoint, almost complete illiquidity.

By contrast, in Peru, this portion of the portfolio will have to be concentrated in companies and sectors having both high growth potential and prospects for early current liquidity, given the dominant tradition of holding on to businesses rather than seeking to sell them for gains.

In terms of investment opportunities, Newfund's requirement for current cash return plus the characteristics of the Peruvian market suggest to us that the primary sources of suitable opportunities will be found in the following areas:

a. Service businesses;

b. Low fixed-asset, labor-intensive manufacturing;

c. Capital-intensive manufacturing in wich the means to increasing efficiencies are identified;

d. Highly selective purchases of State-owned or foreign-owned enterprises on advantageous terms.

The guiding premise, clearly, is that the opportunities in these areas, whether start-ups, expansions, or buy-outs, are most apt to have potential for generating substantial early cash return (or the liquidity and borrowing power) necessary to take Newfund out without requiring either a large capital investment at the outset or successive rounds of capital investment at later stages.

These areas of potential for local entrepreneurial enterprise were confirmed in our conversations with business people, including suggestions ranging from oil field service business, dry cleaning chains, and advertising and related services, to ice cream manufacture and mining of non-metallic minerals. But in the time available we did not see examples of specific enterprises in these or other areas which were sufficiently close to being investible that we could assess their actual potential.

Three points should be made with respect to identification of opportunities. First, Newfund's universe for possible investment will consist of the small, high-growth portion of the total universe of Peruvian businesses which, in 1980, was estimated at 40,000 companies in the industrial sector alone, and nearly double that number if commercial firms are included. Careful selection by Newfund management should yield four to six high potential investments annually.

Second, the areas we have suggested for potential investment are not classic areas of venture opportunity, though they appear to offer unusual opportunity in Peru. Service businesses require a high level of internal control and cash management. The low-fixed asset, labor-intensive businesses will face difficulties with the economics and inflexibilities resulting from the Labor Stabilization laws. We would suggest that some consideration be given to promoting a free trade zone for export-oriented businesses such as electronics assembly, sporting goods, and textile-related goods, that could begin to tap the available labor supply with fewer restrictions. And both in capital-intensive manufacturing and buy-outs of State- or foreign-owned enterprises, a high degree of selectivity and conservative valuation will be required. Recent years of protection and incentives to capital have resulted in creation of many fundamentally unsound firms in manufacturing; these are not candidates. And the majority of the State-owned companies present too many problems for a small venture fund to handle.

Third, the equities in Newfund's portfolio will be valued chiefly in relation to dividend yield and/or book value. Thus it should invest only when the anticipated current yield seems quite secure, and the ownership participation (capital gain) feature is being valued well below expected future book value; if the company is expected to be an attractive and willing merger partner at a premium to book value; if a management buy-out at a premium to book has been negotiated as a part of the deal; or if an unusually high future dividend rate can be sustained for a long time without injuring the business.

A number of opportunities may exist for making leveraged buyouts from the State or foreign owners. While these tend to provide only financial returns without adding substantially to economic value, we do recommend them selectively as an effective tool for Newfund to begin the process of opening capital and of broadening ownership to new entrepreneurial teams, so long as initial valuations and terms of purchase are attractive and the underlying business has economic merit.

As to turnarounds, we suggest they be avoided entirely; unless they present clear prospects for large and very quick returns. Businesses turn down for many reasons, most of which are difficult to analyze from an investor's viewpoint. It is probably beyond Newfund's ability (and mission) to provide the extremely active management assistance required of successful turnaround investors.

4. Fund Structure/Size/Overheads

The Venture Capital Limited Partnership structure proposed for Newfund appears to be suitable (discussed in Legal/Accounting section).

We suggest, however, that Newfund be incorporated as a management company which may establish multiple limited partnerships having finite lives of ten to fifteen years. Newfund can manage these successive partnerships for a fee chargeable to the capital of each partnership over a period of time. This will enable Newfund to accommodate additional capital without difficult problems of valuation and potential dilution of existing partnership interests in any one partnership; to accommodate different investment goals and strategies at different times; and to take advantage of the loss and/or tax credit pass through features that are or may be available to the limited partners. We also recommend that an effort be made to assure that existing reinvestment tax credits are applicable to investments made by Newfund on behalf of its individual or corporate investors. Depending on legal interpretation, current law may be sufficient. But it would be helpful if it were spelled out clearly.

Typically in the U.S. today, the management of venture capital funds is a business in its own right. That is, venture capital management companies are owned by the investment managers rather than by outside investors. Costs are covered from an annual charge to capital and profits are earned from an override on investment income. That format is probably neither advisable nor acceptable in Peru in the early stages of establishing venture concepts and practices. Rather, the investors could own the management company on a prorated basis with their limited partnership interests. (Unlike U.S. law, there is no requirement that limited partnership investors not be involved in the operations of the general partner in order to qualify for beneficial tax treatment.)

We suggest, however, that Newfund adopt an employee incentive compensation plan as part of its annual budget. The plan should create a direct relationship between compensation and each professional employee's performance as measured specifically by impact on portfolio performance. The exact formula of this compensation plan is less important than that it permit employees to make a lot of money if, and only if, they have helped the investors significantly to make a great deal more.

Five million dollars is proposed for capitalization of Newfund, with $1 million to be committed at the outset and the balance firmly committed on call as investments are identified and made. Given returns available, this appears to be the minimum capital necessary in order for Newfund to be able to cover operating expenses within acceptable levels and for it to conduct a potentially profitable investment program.

We have emphasized that acceptable levels of operating expenses will be low necessarily. They should be maintained at a maximum of 3% of total capital annually, or approximately $150,000. In order to maintain expenses at that level, Newfund may have to seek to have some portion of its expenses, rent and bookkeeping, for example, covered by one of the institutional participants in the fund.

5. Management/Staffing.

Newfund's proposed management has not been identified yet, so we are unable to comment on proposed management, support staff and compensation levels.

We suggest that a small team of three people, a general manager, an analyst and an administrative assistant (assuming additional bookkeeping and clerical support can be secured from an investor) should be sufficient to manage the Newfund portfolio for at least the first year of operations. The General Manager in our view should be a well-established senior person experienced in finance and business and past the stage of being highly concerned with risks to his career pattern. He should be assisted by a smart, energetic young analyst with good financial skills and judgment, who sees in Newfund an opportunity to make a lot of money; and by clerical/ administrative support. Such a team should be adequate to make and monitor up to the first eight to ten transactions, depending of course, on their size and complexity. After that, as warranted by Newfund's cash flow, additional professional personnel will be required if one uses five portfolio investments per professional as a general rule of thumb.

The General Manager's role will itself be quite entrepreneurial. Within the normal framework of ultimate authority of a Board of Directors, he will have the following main responsibilities to the Board:

a. formulate and recommend:

   (1) investment policy and budget;

   (2) operating policy and budget.

b. manage policy implementation.

   (1) direct authority over all staff, including selection, termination, job assignments, and terms of employment;

   (2) identification, evaluation, negotiation, and recommendation of investments and divestments.

c. prepare reports.

   (1) quarterly, summarizing all significant aspects of operations;

(2) annually, as above, and also including independently audited financial reports of Newfund detailed portfolio valuations (subject to Board approval), recommendations for budget and policy modifications.

Relative to operations, he will

a. implement investment program:

(1) identify, evaluate, negotiate investment (divestment) opportunities;

(2) establish and conduct internal approval processes;

(3) conduct internal management, administration, reporting processes.

b. monitor and assist investees:

(1) regular meetings with management to review performance versus plans;

(2) occasional meetings with customers, suppliers, and competitors to assess continuing strategy;

(3) specific assistance assignments to extend management's reach:

(a) personnel

(b) technology reviews

(c) market reviews

(d) financial planning and negotiation.

Over and above staff and Board, we think Newfund might benefit from the formation of a small Advisory Committee, comprised of three or four relevant individuals whose role would be to assist Newfund management in spotting both entrepreneurial opportunities and talent, and in promoting entrepreneurial concepts. Such a group would not have formal authority the note, but also to a "bonus" or premium over that rate, stated as a percentage of profit.

We feel strongly that such measures, limited to venture investing, could go a long way toward eliminating a primary disincentive to such investing, thereby beginning to make some capital economically more available to put at risk.

The following general principles for instrumentation will apply to Peru in any event, as follows:

a. Newfund should select for each investment transaction it makes that combination of debt and/or equity instruments that i) facilitates its strategy for the particular investee; and ii) accords with its overall portfolio objectives. To this end, instruments should establish the fund's targetted form, timing, and level of current returns and return of capital. Most important, the instruments should fix, to the extent possible, the desired divestment strategy and capital gain realization.

b. Newfund should seek a priority return of its capital. That is, it should have a right to receive its capital back before any distribution is made on the equity instruments which existed prior to its investment, especially if they are held by owner/managers and other shareholders who have a continuing and active involvement with the operation of the business. At a minimum, in early-stage or start-up companies, for example, the priority should be expressed as a preference on liquidation. In the more established businesses, however, mandatory repayment or redemption dates consistent, of course, with the company's projected cash flow, should be used to assure return of capital and to maintain portfolio liquidity and turn-over.

c. Newfund should seek a priority return on capital, as well. In established companies, this would most likely be achieved through a current interest or dividend yield payable quarterly in cash. In less mature firms, it would more likely be in the form of a cumulative but not currently payable dividend, which would become payable in cash only when cash flow permitted. Otherwise, it would be added to Newfund's preference on liquidation.

d. All the above-mentioned senior instruments should embody whatever financial and other restrictions Newfund believes are necessary. In particular, the fund should seek the right to influence and in some cases control decisions concerning new corporate borrowings, major asset sales and acquisitions, retirements of and distributions on capital, and terms and timing of new capital offerings.

e. Newfund should seek the means to assume full control of policy and, if need be, operations if it begins to appear that the management and controlling shareholders are unable to fulfill the corporate objectives and to meet obligations timely. The senior instruments can provide

Newfund with a power to assume control (by nominating a majority of directors, for example) upon the occurrence of certain events indicating a need for reorganization in the interest of creditors, shareholders, employees, and other interested parties.

f. Newfund should separate the ownership participation feature -- the instrument which will be the primary source of capital gain -- from the instrument which will provide the priority return of and on capital. Thus, the ownership feature can be held conveniently if it is necessary to wait for an extended period while residual values increase or divestment markets emerge. We suggest that Newfund acquire its ownership feature by purchasing either nominally-priced common stock or long-term warrants (rights to buy common stock at a fixed price) at the same time as the initial investment is made. Until liquid capital markets develop, it would not be desirable to use convertible securities, which permit the ownership feature to be turned into gain only by sacrificing the rights to priority return. Convertibles are reasonably serviceable when it is likely to be possible to convert and to divest at the same time but we still prefer in our own investments to separate the capital gain vehicle wherever possible.

The warrant or low-priced common stock generally is turned into gain by sale to the public, or to a corporate acquirer of the entire business or to the company itself. Initial agreements should provide Newfund with certain well-defined rights to participate if a public offering is undertaken, and to liquify in connection with a corporate acquisition.

g. Most important, Newfund should seek whenever possible the right to force the investee company to repurchase its ownership feature to the company if, after a minimum period, no other sale opportunity has become available. This right to "put" may be at a minimum, fixed price. Preferably, however, it is at the highest of the prices produced by formulas relating to (usually multiples of) book value, net income, net cash flow, and similar variables. The terms of purchase should be fixed in advance, also, and may range from an immediate cash obligation to a 2-year interest-bearing note.

7. Shareholders Agreement.

The shareholders agreement establishes a separate set of legal relatonships from those expressed in investment instruments. Specifically, it fixes the rights and responsibilities of shareholders to each other, and may curtail or direct the exercise of some of the rights and claims which a shareholder possesses by virtue of his owenrship of stock or investment instruments.

Relevant for Newfund is the fact that agreements among controlling shareholders may be used to assure that the fund acquires the means to participate in and to influence key management decisions. While direct voting power may be neither the necessary nor the desirable means of achieving this influence in every case, other means include the following:

a. Fixing, by agreement, the composition of the senior policy-making body of the company, including specified individuals or shareholder representatives. Newfund should seek at a minimum the right to be represented on the Board of each investee, either by a staff member, a shareholder, or by a nominee who has particularly suitable experience. Newfund may expect proportionately greater representation in early stage companies in which it has a large capital position.

b. Giving Newfund the right to approve or to veto major corporate decisions usually reserved to shareholders, including major asset sales, acquisitions, and mergers, changes in authorized or issued capital instruments, and the terms and timing of public offerings.

c. Establishing procedures and preferential rights in connection with proposed sales or other transfers of already issued capital. Newfund should always seek right of first refusal on proposed sales, and usually will have to give reciprocal rights to other shareholders.

8. Investment Generation, Analysis, Closing, Monitoring and Divesting.

Newfund's critical staff functions will include all the steps from the initial identification or presentation of investment opportunities to the divestment of those investments which the fund concludes. In between, the process includes analyzing the serious proposals received; establishing the values and terms on which investments may be made in such situations; closing the transactions; monitoring performance of investees to assure to the extent possible that anticipated resale values are realized; and selling the positions off, if possible, within the desired time periods.

The process at the outset is one of narrowing in on a small range of serious investment prospects as quickly as possible from a much larger universe of possible transactions. Substantial time then is spent on those situations most apt to result in investment, and on those in which capital already has been placed. As the portfolio of Newfund grows, staff members will find that time spent screening possible new investments will shrink, relative to time spent on monitoring existing investments and arranging for their sale.

It has been pointed out already that venture management is expensive relative to other forms of investment management. The premium in operations, then, is on reaching investment decision points early, without sacrificing thoroughness.

Certain principles and practices of venture management have become standard in the business and may be helpful to Newfund, as highlighted in abbreviated form here.

Two broad principles apply generally. First, as a management matter, the staff person who analyzes and recommends a situation for investment also should be the person primarily responsible for the results obtained from the investment. And second, unacceptable investments should be rejected early.

On the first point, there is always a tendency to want to separate functions sequentially. Where this approach has been used, specific responsibility for performance of investments has tended to be lost. The performance-based compensation that has been most effective in venture management requires instead that an identifiable staff person be responsible for the duration, even though specific tasks may be carried out within a team framework.

The second principle is critical and requires that the investment managers turn down far more investment proposals than they approve. To give some basis for comparison, the average established venture management company in the U.S. closes five to ten of the estimated 100 to 200 investment proposals that it receives annually. While only 20 to 30 of the total proposals may receive serious consideration, it illustrates the need for early turn-down. Further, the investment process can take as long as six months from presentation of the proposal through all steps to closing, leaving little time for consideration of marginal situations.

If the Newfund concept takes hold, and the availability of equity begins to cause entrepreneurial efforts to crystallize, Newfund can expect substantial demand for its capital over time. It therefore should be in a position to be highly selective regarding the opportunities in which it chooses to invest.

Newfund's management should, from the outset, maintain a small file of companies of possible future investment interest. These are companies which, while promising, lack one or more critical dimensions when first presented for investment consideration though they may be suitable at a later stage of growth.

Apart from these broad guidelines, there are narrower points which can be made in each functional area.

a. Investment Generation.

Newfund does not start with a "pipeline" of potential transactions. As already indicated, we believe it will have to work hard to develop a "deal flow" in sufficient quantity and of sufficient quality to enable it to identify the best potential investments in the country. And we have suggested as part of the start-up strategy alternative steps it might take to establish its presence and purpose clearly. Beyond that, establishing a regular flow of possible transactions will depend mainly on Newfund's doing three tasks, as follows:

- Establishing clear investment criteria and guidelines as to the form in which proposals should be submitted to it;
- Keeping key sources of potential transactions informed as to the types of situations that Newfund is seeking;
- Establishing sufficient authority at the outset over the deal generation process that it avoids being influenced to finance transactions that do not serve its overall goals.

Investment criteria should specify anticipated average size of investment; industry preferences; industry exclusions; allowable uses of proceeds of the investment; desired stage of growth and financial characteristics of prospective investees (e.g., preference for established businesses with operating profits for the preceding two years, with opportunity for accelerated growth); special requirements of Newfund as an equity-type investor; and locational preference, if any. As a matter of operating procedure, these criteria will change from time to time, within the limits set by prevailing general policy.

Guidelines as to the form in which investment proposals are submitted to it will be as important to Newfund as the criteria themselves.

> Except in those cases in which Newfund is itself the originator of an entrepreneurial enterprise, it is critical that the fund require fully-developed business plans from entrepreneurial managers seeking their assistance, since it is the business vision and skill of the entrepreneur which Newfund will be evaluating and backing when it invests.

Detailed business planning for financing purposes is not common in Peru, and Newfund will have to develop its own guidelines for such documentation. By way of illustration, however, in the U.S., such business plans generally treat the following comprehensively:

- description of product or service
- proprietary aspects of technology, if any
- market strategy
- key management
- capital required
- use of proceeds
- ownership of structure
- pro forma financial statements for a minimum of three years
    - balance sheets
    - income statements
    - cash flow (by month for Year I)
- risk factors

More sophisticated plans include both the pricing and structure of the proposed investment, as well.

Both investment criteria and submission requirements should be made known to a limited number of key individuals or institutions who are situated so that they are likely to generate suitable opportunities for referral to Newfund. This would include its investors and directors, as well as local bankers, accountants, investment bankers and selected businesspeople.

Newfund's authority in shaping its deal flow will result from the clarity of its criteria and from its pinpointing likely sources. Excessive general publicity on a continuing basis may result in its receiving a high number of unsuitable proposals.

b. <u>Analysis</u>.

The analytical task of staff will be facilitated immensely if well-thought-through business plans are required from entrepreneurial management, as suggested above. Newfund then will have to satisfy itself that the elements of the plan are sound, and that they make sense in terms of its own objectives.

Peru appears to have a substantial number of well-trained financial analysts in credit institutions. We assume that this pool will be tapped in staffing Newfund. The only general distinction to be made here insofar as venture analysis is concerned is that substantial additional investigation is required of a business plan and financial projections through conversations with suppliers and customers, both current and prospective. And, since the portfolio strategy will be heavily reliant on current yield as well as eventual capital gain, it is essential that all elements of cash flow be understood clearly.

Overall, the analytical process is geared to identifying the major risks associated with a venture; establishing the validity of the financial projections for purposes of understanding the business as well as for valuing the investment; and to ascertaining the prospects for future divestment. Experience shows that financial projections initially presented by most entrepreneurial managers tend to be overoptimistic. In the course of analysis, they frequently are revised downward.

c. Closing.

The section on shareholders agreements touched on the principal substantive issues associated with stock purchase agreements in venture financings.

The documentation involved in venture financings, however, is not standard and is not easy to do, principally because so many elements are tailored to the specific transaction at hand. We would suggest that Newfund work with one or two lawyers, and one or two accountants, to develop expertise in this area over time.

d. Monitoring.

The monitoring function is an active one, the point of which is to anticipate problems or potential problems early, and to institute such corrective action as may be feasible and necessary. The principal means used to monitor include reviews of regular financial reports and supporting documents, as may be required (such as aging of accounts receivable, out-of-stock inventory reports, and so forth); regular discussions with owner/managers; and periodic checks with suppliers and customers.

The principal monitoring tool, however, is the annual budget. Management of each investee should be required prior to the commencement of each fiscal year to prepare a detailed budget, by month, reflecting the strategy and expected results for the year. This document, then, contains the year's objectives, spelled out in substantial detail, with assumptions. Actual results, by month, should be compared with budget, with variances from budget, whether they are above or below, explained.

Newfund's management should receive interim comparative statements monthly from investee management and use these as the basis for regular discussions of performance. If a seat on the Board of Directors of the company has been a condition of the investment, then the comparison of the budget to actual results should be the focus of regular Board attention.

e. Divestment.

Issues related to divestment have been discussed throughout this report; these will not be repeated here.

It should be reiterated only that, in the absence of ready markets for liquifying positions at this time, it is likely that Newfund will have to rely in the near-term on management buy-outs as its principal means of liquifying its positions.

9. Legal/Accounting.

The provisions of the Peruvian Ley de Sociedades Mercantiles present no special obstacles to the operations of Newfund.

With the exception of the participating interest bond that we have suggested, all of the instruments proposed for use by Newfund are permitted under current law, including the warrants suggested for use, which would not be prohibited. Warrants often originate in association with another security, subordinated debentures or preferred stocks, and are detachable from them. They confer on the note- or shareholder a right for a specified period to purchase common stock at a pre-established price, even though the note may be paid off fully or the preferred shares already redeemed. Expressed commonly as "a note with detachable warrants," these instruments permit an investor to recover the investment, with interest or dividends, while retaining an interest in the residual value of the company. Warrants will give Newfund a means of biding time with its equity positions, as the capital market evolves.

The participating interest bond, if Newfund management decides to create and use it, will have to be subjected to legal review.

On securities valuation, the law prohibits the sale of treasury stock at a value below par, but par can be established at low value, so that that should not be a problem.

Capital gains are not generally taxed, unless such sales constitute "habitual activity," defined under the law as more than ten such sales in a two-year period. Given the relative inactivity in the Peruvian market, it is unlikely in the foreseeable future that Newfund will have that level of securities sales transactions or even that individual investors would, should the tax event occur at the level of the individual investor, as it will in the limited partnership structure.

The limited partnership provisions also are adequate. They permit pass through to investors of the benefits of Newfund's investments, so that multiple limited partnerships can be created if losses are expected. There is a limitation on the number of investors (up to twenty), but this does not appear problemmatic. Finally, corporations can invest as limited partner; this is expected to be the preferred mode of investing as Newfund is formed.

Accounting standards also are spelled out in the same law. Apart from reporting requirements imposed on registered companies and designed to insure adherence to generally accepted accounting principles, these present no special difficulty.

The bankruptcy law similarly does not in itself present obstacles, but it is significantly less flexible and less tolerant of debtors than U.S. law and should be more of a consideration in choosing lenders, trade suppliers, and co-investors.

We suggest only three areas of prevailing law for review and possible modification, as follows:

a. Provision should be made, if possible, to have all investment tax credit incentives available to individual and corporate investors on a pass-through basis to investments made in (and through) Newfund.

b. The current tax on dividends is a serious disincentive to venture investing as long as interest can be received tax-free.

   We suggest either that elimination of the tax be sought for qualified venture investments, or that an interest-bearing security having profit participation be created and used. (Discussed on page 53.)

c. Elements of the Labor Stabilization laws, in our view, will continue to hamper the ability of Peruvian enterprise to take advantage of market opportunities.

   We suggest that some consideration be given to reasonable and potentially accpetable means of utilizing abundant surplus labor. We already have suggested mounting an export-oriented free zone.

   Possibly also, however, a permit might be secured for new enterprises to hire anyone at anytime providing their proposed compensation rate is at least 10% (for example) above their previous compensation rate over a five-year period.

We recognize the complexities of legal changes anywhere. The positive effects of the three mentioned here would be substantial for an effort such as Newfund.

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Addendum

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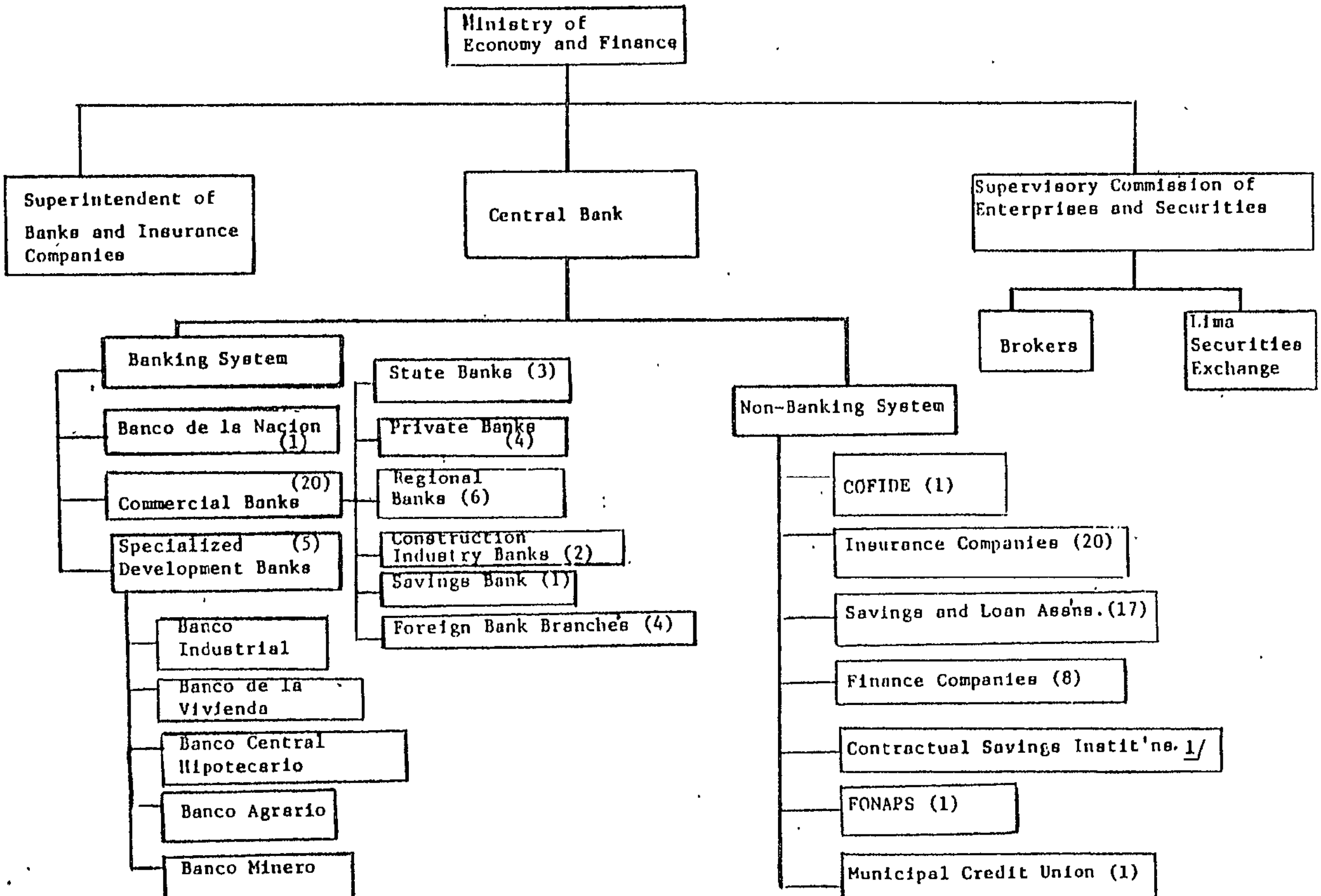
Figure 1

Structure of the Financial System
(as of December 31, 1979)



1/ Contractual Savings Institutions comprise cooperative savings associations and capitalization companies.

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