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VENTURE CAPITAL IN BOLIVIA: AN ALTERNATIVE FOR RURAL FINANCING?

Overview

Introduction

Financing the economic activities of the rural world is one of the biggest challenges in the fight against poverty and rural development in Bolivia. The nature of this sector makes financing particularly risky and very expensive. For this reason, there are few financial institutions involved in the campaigns, and the financial products that they offer are badly adapted to the needs.

In this issue of Zoom we analyse a new tool, venture capital, through the experience of two venture capital funds in Bolivia: the Rural Development Programme (PDR) and the Programme for Investing in Companies (PIE).

Reasons for the emergence of venture capital funds in Bolivia

Venture capital funds are intented to foster the rural producing sector and strengthen production and marketing activities where rural populations are involved. These funds are the result of the following assessment:

- Like in many Southern countries, the Bolivian financial sector shows several flaws. Banks have renounced to work with rural populations and consequently with small producers. Most of their activities are focused on urban centres and their periphery: 94% of their portfolio is concentrated on the main axis: La Paz – Cochabamba – Santa Cruz, 82% of which corresponds to 6% of the borrowers. The financing of the rural sector remains therefore very limited.

- The Bolivian producing sector consists mainly of rural producers (65%) and microcompanies (18%). These have limited market access and seldomly adopt the configuration of a well structured producing, processing and marketing sector. This fact, among other reasons, restricts their development and access to financing sources. In order to prevent their exclusion, and in the framework of a poverty reduction strategy, the State is developing groups of small rural companies trying to integrate them into marketing channels.

- The limits of microfinance were put in the spotlight by the crisis of 2000, when microfinance institutions faced problems of insolvency and non-reimbursement by their clients. This setback showed the limits of a tool that, on its own, cannot fulfil all the financing needs of the economic activities in the rural sector. Credits are not very flexible, they have conditions and are ill-adapted to the arbitrary aspects and maturing time of the activities in the agricultural sector. The relatively low amounts granted are insufficient to respond to the companies' growth. Most microfinance institutions apply a high interest rate (2-3% per month) because their target is to achieve continuity and financial sufficiency. Finally, they prefer short term investments and often lack long-term stable resources.

Therefore, venture capital funds were created in order to contribute to the development of the rural producing sector by meeting the financial needs that microfinance could not satisfy, and to tackle the shortfalls of both the State and the formal banking system.

What is venture capital?

Venture capital is a type of financing recommended by specialised investing companies to young companies showing good growth rates and great potential, but which lack sufficient own funds or have no access to credits.

According to the InterAmerican Development Bank, in industrialised countries, venture capital is intended to foster the development of innovative technologies or new products, whereas in developing countries, the meaning of venture capital has a larger scope. Its objective is to support the development of young companies during their first years of existence. These investments, that allow the companies to advance in their development, are made by taking shares in investment companies that are funded through the return on investments, via the dividends and

Main differences between credits and venture capital

	Credit	Venture capital
Cost	The interest rate is fixed and based on the size of the credit, regardless of the company's returns. Interests are paid at a fixed period ex ante.	Investors are paid according to the obtained returns, through dividends and gains of divestiture at the end of the investing period. Returns on investment are fixed ex post.
Duration	The rural credit is generally granted for a short term (less than a year). In case of failure, debt rescheduling is possible, but there is limited flexibility.	The investment period is not always defined, but it can be fixed in a contract, according to the expected results. There is normally a long term investment (3-10 years, depending on the sector).
Guarantee	The guarantee – normally real estate – is essential in order to have a credit. It allows to cover for the risk of non-reimbursement.	The company and the projected returns and cash-flow are the main investment guarantees.
Risk	There is a risk of non-reimbursement by the borrower. This possibility is thoroughly studied, and therefore the risk is moderate.	By definition, the risk of the investment is very high and the risk involvement is shared between the investor and the company. The expected return is proportional to the risk.

gains obtained with the divestiture or selling of their share at medium or long term (3 to 10 years depending on the sector). These investments have an extremely high uncertainty rate, and a few successful projects must make up for the capital loss of the numerous failed projects.

Two experiences of venture capital funds

Venture capital funds have been multiplied and diversified in Bolivia. Some are supervised institutions that operate on term deposits, government bonds and shares of companies listed on the stock exchange. Others, such as the Rural Development Programme (PDR) of ProCredito and the Programme for Investing in Copanies (PIE) of ProRural are non-profit institutions focused on rural development that own private funds, public funds or funds from international cooperation.

■ Objectives, approach and beneficiaries

The PDR and PIE contribute to the fight against poverty in rural areas by offering tailor made financial services (capital through equity shares) to organisations (producers' associations, cooperatives, companies, individual producers and NGOs) that focus on the production, processing and marketing of rural products. They are usually small and medium sized enterprises, both formal and informal and are located in rural areas or close to towns.

In June 2004 PDR and PIE investments amounted to 2 million dollars for 46 investments. These are concentrated in the primary sector (several agricultural products, fishing and livestock products, wood, cochineal, flowers) and the secondary sector (agro-food, textile, medicine and construction industries). The services sector only has one tourism project. However, eco-tourism is a growing sector with great potential.

Portfolio of PDR and PIE investments per sector (June 2004)

	Number of investments	Share of overall investments
Primary sector	32	75%
Secondary sector	13	23%
Tertiary sector	1	2%
Total	46	100%

■ PDR and PIE types of action

Venture capital funding is addressed to profitable organisations with positive financial perspectives. Projects must show at least an expected 10% return per year. However, they must also have a significant social impact on the rural area (income rise through the development of commercial outlets, job creation, etc). Partners must have at least 3 years experience in their field of expertise, own an established business and show a transparent management of their activities.

There is a high demand for this type of financing. From 332 projects that applied for venture capital finance, only 15% were approved. Each application is assessed by an internal committee before it is sent to an external credit committee normally consisting of donors. Once the project is approved, the increase of capital is made and in certain cases a new company is created (between the venture capital funds and the company-beneficiary). Upon termination of the contract, the venture capital funds give their shares either to the company or to third parties and the created company is disolved. The gains are distributed proportionally according to the shareholders' participations.

The amount of investments ranges from 5,000 to 300,000 dollars. Such capital contributions serve as investing or operating capital.

IRUPANA: the development of a company's culture

Irupana is a public company created in 1987 by small producers of the town of Irupana in the Yungas (North of La Paz department). It deals with the collecting, processing and marketing of biological agricultural products (coffee, cereal, fruit, honey, etc). Currently, the company has more than 1.700 small producers as suppliers and 110 employees. It commercialises 80 products in about 300 sale points (of which 18 are owned shops) and exports to Europe, the United States and Asia.

Irupana has contributed to the region's development and to turning the local economy into a more dynamic one, offering interesting market outlets to the region's small producers (from whom it buys the production at a 5 to 15% higher price than the market price). The relationships between suppliers and buyers have enabled the development of a company culture in the farmers' communites focused on turning small producers and suppliers into their loyal and responsible partners. Irupana wants to integrate its suppliers further in developing the company in the region. With the aim of strengthening the sector and improving the quality of production, small producers have partially (50%) taken up the costs of building the drying and stocking facilities. Irupana, in turn, committed itself to buying the harvests. Irupana has recently decided to step ahead and offer the possibility to its suppliers and employees to become shareholders of the company (up to a total amount of 33% of the capital respectively).

■ A summary of the impact

Investments have an impact on both the beneficiary organisations and their implementation area:

FLORALEX: the development of local economic activity

Floralex is a small company installed in Quillacollo, in the Cochabamba valley specialised in flower growing (roses and carnations) and has 42 employees. Floralex has profited from venture capital shares, leading to a 90% capital increase and the renovation of its infrastructure. The flower production experienced a 58% increase in 2 years. The company is in the process of being granted legal recognition, and an accountant has been recruited.
Floralex is now the second largest company in the Cochabamba valley. More than 50% of the national production is concentrated in this valley, which has a favourable climate for floriculture. Competition inside the valley is weak because supply is lower than demand. However, if producers worked in a more coordinated way, they would be able to satisfy demand better while reducing their costs.
Floriculture is still at a very early stage in Bolivia, but it has enormous potential. Floralex is well aware of this, and has therefore established close links with the association of flower producers of Cochabamba (about 30 people) and suggests developing strategic alliances among producers. It also plans to create a common centre (for the sorting, washing, packing, stocking and marketing activities) in order to improve quality and cut costs. In this framework Floralex supports several small local companies, contributing in this way to the strengthening of the producing sector in the valley.

- The effects of investments on the beneficiary economic entities can be seen in different ways, like economic and financial strengthening, isntitutional consolidation (legal support in the process of legal recognition), improved management (particularly accountancy) etc.

- The impact of investments in the area is equally significant. Venture capital partner companies are related to some 15,000 families. In the case of PDR the transfer of monetary resources to rural areas (income from the selling of raw materials, employees salaries, services rental, etc) represents 85% of the toal amount invested in venture capital. Investments also allow to create or keep jobs. In the case of PIE almost 300 jobs were created.

- Apart from the three-pillar system company/employees/suppliers, local economic activity is fostered. Similar initiatives arise and contribute to the development of the entreprenaurial spirit of small producers. Rural polulations increasingly take part in the market dynamics, giving way to a snow-ball effect. It is difficult to measure the effects, but they have a significant impact, particularly on rural exodus.

■ Several challenges

Despite numerous advantages offered by this new financial tool, there are still a lot of challenges.

— How can we meet the financial needs of the rural producing sector?

Venture capital is better adapted to the constraints of the agricultural sector than traditional credits, but it is not yet the answer to the financing needs of production activities. They are considered too risky due to the nature of the activity and the products (climatic factors, illnesses, fragility and limited life of products, etc) as well as the lack of socio-political stability that brings the country to a halt every so often. Therefore, venture capital investments are not applied to production phases if these are not linked to processing or marketing activities. PDR and PIE are primarily focused on collecting and marketing activities (like in the case of coffee).

Venture capital does not always constitute an appropriate response to the growth and investment needs of the producing sector. Restrictions to use the capital exclusively for operating capital (as it is the case for most PIE investments) limit the possibilities of growth of beneficiary organisations and these cannot make the qualitative jump in their development, what in turns limits the impact of the tool.

Finally, since the objective is to fight poverty, venture capital is addressed to organisations that are sometimes not fully consolidated. The weak management and governance can constitute an obstacle for good financial relations adapted to the rules of venture capital. Moreover, not all of the organisations are legally recognised. PIE accepts a certain informality so as not to exclude small companies, whereas PDR only works with companies committed to undertake arrangements towards legal recognition.

— How to manage risk in venture capital funds?

PDR and PIE face major challenges, particularly when it comes to mastering risk management costs. Their financial autonomy is not yet guaranteed. Therefore they are confronted with an eternal dilemma: should they aim for a greater social impact, while risking failure and higher operational costs, or should they opt for a more financial approach thus limiting risks and costs, but having less social impact?

In order to ensure the continuity of the system the selection criteria for venture capital funds are relatively strict, thus excluding certain organisations from access to venture capital. From 46 investments, less than half show the expected results, demonstrating the risk in the sector. However, several risk managing mechanisms have been developed for venture capital funds that allow for the minimisation of risks.

Investments are spread throughout the Bolivian territory. Despite efforts to move away from the most developed urban and periurban areas, La Paz is the best served department (65% of the total amount invested by the funds). Moving away from the La Paz-Cochabamba-Santa Cruz axis implies high operational costs and risks. Therefore venture capital funds focus on urban and periurban organisations whose activities have a direct impact on rural populations located outside this axis.

Finally, apart from opening access to financing, technical and managerial support is often needed. Venture capital funds carry out the follow up of their investments and in certain cases managerial support is offered, which adds up to the operational costs and surpasses their functions, but at the same time it allows to reduce the risk.

Conclusion

Venture capital allows to meet the financing needs of certain economic entities which are excluded from the traditional financial services and for which credits are not well adapted. These entities deal with processing and marketing activities but their impact is far larger, because many small producers find market outlets for their production through them.

However, venture capital is a financial tool with limitations, and it is just one of several solutions to the problem of financing rural activities. Besides, we lack the experience to draw conclusions and learn lessons from the venture capital activities of PDR and PIE. The tool is still being developed, and PDR and PIE are in the learning phase.

Finally, the success of venture capital also depends on a number of external factors such as the macroeconomic stability of a country, the transparency of markets, a favourable environment for private investment, a solid legal system, etc. and its sustainable implementation in Bolivia is a real challenge. ■

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Authors: Aurore de Crombrugghe, manager of Support to Latinamerican Partners at SOS Faim, and Clémence Regamey, student/trainee at SOS Faim – Bolivia.

SOS Faim and microfinance

SOS Faim has been working for several years in the microfinance field and supports partners involved in this sector in Africa and Latin America. As with all development tools, we have to analyse the aims, models and implementation conditions of microfinance. With this frame of mind, SOS Faim edits "Zoom microfinance". You can find this publication and download it in French, English and Spanish on the website of SOS Faim Belgium: www.sosfaim.be

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SOS Faim – Action pour le développement
Rue aux Laines, 4 – B 1000 Brussels – Belgium
Phone : 32-2-511.22.38 – Fax : 32-2-514.47.77
E-mail : info@sosfaim.be – Site : www.sosfaim.be

SOS Faim – Action pour le développement
Résidence "Um Deich" bloc C, 9 rue du Canal
L - 4050 Esch-sur-Alzette – Grand Duchy of Luxembourg
Phone : 352-49.09.96 – Fax : 352-26.48.09.01
E-mail : info@sosfaim.org – Site : www.sosfaim.org

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Responsible editor: Freddy Destrait, rue aux Laines 4, B 1000 Bruxelles