

Angel Investors in Chile¹

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Abstract

The paper presents the results of interviews with angel investors and experts around the risk capital industry in Chile. It focuses on common practices in seed-stage and/or angel investing and on how have those approaches been shaped by the country's culture.

The paper describes how angel investing works in Chile: how do they contact and select opportunities, what resources do angels tend to bring to their firms, how do they partner. It also includes some history of angel investing in the region and a mention on how local legislation has contributed to shape the industry.

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1. Background

Angel investing is an issue that has not received much attention in Chile. As in any other part of the world, angels have been active in Chile for a long time, but we still have little information on how they receive deal flow, how they invest, what relationships they develop with entrepreneurs and the new firms, and how they exit. This study will not make an in depth description of how angels act in Chile, rather, it will show a few prevailing practices and provide some understanding on why angels in Chile are working that way. The study is part of an agenda focused on creating the basis for a dynamic entrepreneurial system in Chile. A system with qualified and committed entrepreneurs, strong deal flow and a professional angel and venture capital community. In this manner, the study is exploratory and its objective is to shed light on what issues seem critical for the development of formal angel investment in Chile. The study is based on experience from our work developing an angel network in Chile that could attend the deal flow stemming from Chilean business incubators and national business plan competitions, and from more than 20 semi-structured interviews with angel investors and experts.

2. Chilean legal, economic and cultural context

Since its early independence days Chile has developed a culture of respect to law and institutions. With some minor ups and downs, this tradition has persisted until now and Chile can be considered a law abiding society, where citizens tend to respect their agreements. This respect for formality was not coupled with an open economic environment for much of the twentieth century. These two forces may have contributed to highjack entrepreneurial initiative. Formality may have contributed to a deep negative perception of failure, and an aversion to engage in entrepreneurial activities, as unsuccessful entrepreneurs can not honor their commitments. In addition, the economic consequences of a failure were also high because people that leave unpaid debts get posted in a public financial database and their credit opportunities become almost nonexistent. After more than two decades of economic reform, still about two thirds of the angels interviewed responded that Chilean entrepreneurs are too afraid of failure. More in depth questioning brings out the assertion that this trait is produced by a difficult reinsertion in the Chilean business society after a failure. A few angels could tell stories of failed entrepreneurs that were ostracized by their peers after failing in their business venture.

During most of the last century the economic environment was negative for entrepreneurs. The state was in charge of leading new productive initiatives and the business owner was perceived as opposed to the improvement of people's conditions. Only in the last two decades of the last century did Chile produce a structural economic reform that freed the economic system and permitted the acceleration of economic growth. With growth, poverty decreased rapidly and the image of the entrepreneur changed from a person who takes wealth from others to a more positive image of a person that creates wealth for others.

Chile is now a very open economy, during the last two years Chile has signed free trade agreements with several countries and two of the mayor trading blocks of the world: the US and the European Union. Chile is also an active member of the APEC and in 2004 is the host nation for this meeting. Chile has seen growth coming from its export strategy for the last 25 years, however much of that internationalization was due to exports of large resource intensive firms and almost none from small innovative firms. The new free trade agreements are contributing to create an environment that provides for many business opportunities, a context where innovative entrepreneurs may find more fertile grounds.

The internal legal environment has also changed. Although some changes are still due to create a more dynamic entrepreneurial environment, the current Chilean legal context is very friendly to entrepreneurs and investors. The first initiative to promote risk capital came in 1989 when a new law enabled private pension funds to invest a portion of their portfolio in new ventures. This law provided a large supply of funds to become available for new business development through a new business investment instrument call FIDE. Since 1995 total investments made through FIDE's have stabilized around 200 million US\$, and about three

fourths of these funds have come from pension funds (SVS 2003). Since these institutional investors are very risk averse and have long term financial commitments, most of FIDE investments went to real state and other low risk – long term maturity investments.

In 1996 the government, through CORFO², also created an instrument to partially fund venture capital funds. This instrument opened the doors for new investors and started the venture capital industry. But these new actors had still to ride the learning curve. In addition, in 1998 Chile received the ripple effects of the 1997 Asian Crisis. A recession brought down the stock market and real state became a poor option for FIDE funds. Some of the money in these funds turned to alternatives. These turn of events started a timid search for new opportunities in more risky business, among them, dot com companies.

Several reasons, such as low deal flow quality, limited availability of exit strategies, strong risk aversion of Chilean investors and the perception that Chile did not possess local scale to gain from the dot com frenzy may explain why Chilean investors did not invest much, and did not suffer as much, from the dot com bust. Still, local investors wrote down the lesson and became much more wary of risk investment, an attitude that was reinforced by a slow local and international economy.

In 2000 the Chilean government passed a capital market reform law that produced a better legal environment for risk capital. Exit was promoted by the creation of an Emergent Stock and capital gains taxes were reduced for first buyers of these stocks. These positive changes came almost together with new laws making more rigid the labor market, a reform that may have hampered the creation of new firms. Over the next 3 years entrepreneurial activity grew at a very slow pace. Fortunately over that same time several institutions have been put in place that have made a contribution for a better entrepreneurial system. Several universities, with government sponsorship, have created business incubators and business plan competitions that are providing important deal flow.

With better deal flow, more seasoned entrepreneurs and the acceleration of growth during 2003 and 2004, we are now seeing a renewed interest for new investment opportunities. Investors are again becoming more optimistic and willing to play the entrepreneurial game.

3. Entrepreneurship and deal flow in Chile

Investors overwhelmingly hold the view that deal flow in Chile is scarce and of low quality. In a survey of 79 angel investors³ in 2001, 83% of angels said they had not received attractive or credible business proposals. In the survey performed for this research, almost all investors complained that deal flow was not adequate, while 36% thought projects were too risk, 21% that entrepreneurs were not credible, and only 7% blamed the low investment rate on lack of knowledge by the investor. These figures highlight that new ventures are created within a system where at least three things have to be there: risk investors, deal flow and qualified entrepreneurs. The latter being more important. In the 2001 survey, more than twice as much investors thought that the entrepreneurial founder and team was more important than the business proposal.

Our experience of many years working in entrepreneurial education at Universidad Adolfo Ibañez leads us to think that young people in Chile come less prepared to engage in entrepreneurial ventures than in the US. College students do not get work experience and do not have as many leadership opportunities as in US high schools and universities. In addition very few colleges in Chile have considered entrepreneurial education in their curricula. This was specially true for the top universities, with some exceptions. In top universities, business

² CORFO is the government arm in charge of promoting production and innovation.

³ Romo (2002), Angel investors, Agentes estratégicos en las primeras etapas de formación de emprendimientos, Ventures Latinas, www.ventureslatinas.com.

students were prepared to be managers, not entrepreneurs. An entrepreneur was somebody that could not get a good job in a large, established company, and needed self employment.

Thus, the current cadre of would be entrepreneurs is composed to a large extent by people looking for self employment. The GEM (2003) study shows that Chile is among the top nations in the world survey in Total Entrepreneurial Activity (TEA), but, as in most Latin American countries, a large part of it is “necessity entrepreneurship” rather than “opportunity entrepreneurship”. Nevertheless, there is an increasing number of entrepreneurs that are self made people and that have the guts and professionalism to engage successfully in the development of new ventures. Many of these new entrepreneurs come from the science and engineering areas and have a strong bias towards the product rather than the market. Their main challenge is how to get the business skills to develop the business while the opportunity window is still open. Fortunately, these people now have options to get better prepared as they engage in their ventures.

Several universities are giving strong steps to change their business curricula and create an environment more friendly for entrepreneurs. Currently there are about 12 business incubators in Chile, most of them associated to a university. These incubators not only provide space and some common services, but are also providing some education and helping develop entrepreneurial skills and business plans more tuned to the market.

A few universities are also organizing business plan competitions with some training in the process. One of them, ChileEmpresario, gives business plans workshops, elevator pitch workshops and investment forums with angel investors and venture capital. It also provides incubation and consulting services, in addition to prizes, for the winners of the competition.

With these initiatives already going strong in the market we should expect a marked improvement in deal flows and qualified entrepreneurs in the next years. With deal flow and entrepreneurial capabilities improving, we can also expect an increased interest from angel investors to come and play the game. There are many rich people in Chile that have made money through exports of natural resources and that can not find new investment opportunities in those same sectors. These investors are not active in the angel market yet, but as a few new venture winners come into the picture we may see a large influx of this money into the risk capital market.

4. Chilean angels

This section draws from interviews with 20 angel investors and experts and from previous studies on Chilean angel investors done by Alicia Castillo, a venture capital fund manager for Venture Latinas (Castillo 2002).

Chilean angels are usually ex-entrepreneurs with good business experience. The 2002 survey showed that 63% of them had been entrepreneurs. In the 2004 survey almost all of them had created a new venture and three out of four had also been managers for a different owner. They not only bring entrepreneurial experience, but also some investment experience. In the 2004 survey, all but one had already invested in start ups. These investors have made money in their business and want to invest a fraction of their assets (around 24%) in new ventures, mostly for the expected return (79% of them said so) but also for the personal challenge (43% of them).

Angels are still cautious because they have seen, and a few experienced, the dot com bust. Nine out of ten angels thought that, in general, Chilean investors were risk averse and suspicious when they evaluated a business opportunity. However, when you talk more openly with them, they tend to highlight more positive aspects. Clearly, the economic landscape is more friendly, investors are more experienced, the legal environment is more secure and open, entrepreneurs now understand risk investment, and society has a very positive attitude towards

these new “economic heroes”. In spite of bad past experience, most angels are very comfortable with the current investment environment. Eight out of ten thought that the legal and cultural context was favorable for angel investment, although improvements could still be made. Special mention was made to the need of exemption of capital gain taxes for all investors that participate in the new venture and more liquid stock markets. Currently only first holders of IPO stock are exempted of capital gain taxes for a period of five years. On the cultural side, investors would like to see better qualified entrepreneurs and argued for better entrepreneurial training at schools and universities.

Investors practices and relations with entrepreneurs are varied, but there are some common places. Chilean angels are very open to receive business proposals. Three out of four had entrepreneurs contacting them directly and almost all of them received proposals by referrals of professional contacts and business partners. Less than a third had received proposals through family and friends. These numbers suggest that angels tend to take investment decisions in a professional way. Most of them are passive in their search strategy, only four out of ten were active in looking out for opportunities.

When opportunities come their way, they prefer a 2-3 pages executive summary as a first proposal. Better if it is accompanied by CVs from the entrepreneurs. After that, they would like to have a personal interview with the entrepreneurs before looking at a complete business plan. They tend to look at early stage companies, with nine out of ten having invested in start-ups.

When they invest, two thirds of them said they prefer to become part of the controlling group of the investment. Half of the investors interviewed co-invested with other angels. The emphasis on taking control probably reflects lack of confidence on minority shareholder rights. For a long time the law did not protect these rights strongly enough. Although the law now protects these rights, culture may change at a slower pace. Investors also understand the value of their experience for the success of the new venture, committing on average 8 hours a week, mainly to help making strategic and financial decisions.

Results were lightly skewed to the negative, with half of our sample responding to having had lower than expected returns and somewhat less than a third having had superior than expected returns. Given the naturally optimistic nature of investor's expectations, these results may not be that bad. Returns are expected mostly from capital gains, although a solid third preferred dividends. Interestingly, a few experienced investor-entrepreneurs stated that dividends were crucial because they contributed directly to profit and in addition made the firm more saleable. Sales occur on average between 5 to 6 years after the initial investment and more than half of sales are to third parties, while a third of them are purchases by other partners.

5. Conclusions

A few interesting conclusions from this study are that unlike US angels, Chilean investors are more cautious in their relationships with entrepreneurs. They tend to gain control of the new venture and have a more hands on approach to management. Entrepreneurs are also more cautious, mostly because society is less tolerant to failures. In addition, compared to the US, young graduates are less prepared to become entrepreneurs because they usually lack work and project management experience. These combination of effects makes the angel investing market more rigid and lowers the amount of possible deals.

Compared to other Latin American countries, local investors are perceived well by society and the legal and economic context is more friendly to angel investing. Thus Chile may not have yet the conditions to have a driving angel investing market as in the US, but local conditions seem to be much better than in the average Latin American country.