The Surge of Venture Capital in Latin America

Venture capital is on the rise in Latin America, where startups are tapping new markets as technology spreads. This article examines the growth and explains why VC investors are drawn to the region.

When Sebastian Kanovich co-founded Uruguayan fintech startup dLocal in 2016, he struggled to get international investors to demonstrate interest.

"It took us a lot of no's before getting the first yes," he said in an interview with Reuters. "We were not only from Latin America, but from Uruguay, not known for technology."

Six years later, the story has shifted.

In June 2021, the company went public on the Nasdaq exchange and raised $617.65 million in its IPO. The valuation has risen to $5 billion since then, and the company has formed partnerships with tech giants such as Amazon and Google in 30 countries across Africa, Asia, Latin America, and the Middle East. Other Latin American tech firms, such as Brazil's mobile-only Nubank and Colombia's food delivery startup, Rappi, are also riding this wave of increased investment.

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The international venture capital sector has been growing steadily over the last few years, and Latin America has been cashing in. While the region has ways to go before it reaches the level of Asia, Europe, and the United States in terms of the volume of VC investment, the widespread and increasing use of smartphones, payment cards, and internet penetration has paved a boom in demand for digital services. Latin America's rising middle class and consumption habits have also been a catalyst for private-sector investment and growth.

The economic potential of the region is undeniable. It is one of the largest economies internationally, with 660 million people and $6 trillion in GDP. To put it into context, the population is twice the size of the United States (roughly 330 million people), and its economy is three times that of Africa's. What's more, the region is urbanizing at a rapid rate coupled with increased digitization and internet penetration. Despite the social and economic costs of the COVID-19 pandemic, the economic outlook for Latin America is also bright. The International Monetary Fund projects that the 2021 regional growth forecast will be at 4.1 percent. And as Latin America's economies continue to grow, so does its middle class, which means that the population will have higher levels of disposable income.

Though Latin America has grown considerably since the beginning of the 2000s, its most notable increases have been made over the past few years. According to a report from the Latin America Venture Capital Association (LAVCA), VCs invested $11.5 billion across over 400 deals in Latin America through the third quarter of 2021. Interestingly, this figure is greater than the capital invested in 2019 and 2020 combined, and greater than what was released between 2012 and 2018.

Venture capital has taken off for a myriad of reasons, most notably increased international interest in the region. In 2019, SoftBank, a Japanese conglomerate holding company, launched its first-ever Latin America-focused fund of $5 billion, focused exclusively on investing in technology startups in the region. According to Miguel Armaza, co-founder and managing partner of Gilgamesh Ventures and a Wharton/Lauder graduate, Softbank's investment kickstarted a wave of international venture capital investment. Capitalizing on this momentum, in September 2021, Softbank committed another $3 billion for Softbank Latin America Fund II to further drive technology adoption in the region.

The region has become attractive to investors who see the young, underserved population, growing internet infrastructure, and rising middle class as a blue ocean opportunity. Latin American startups receive international support from funds in major tech hubs such as Silicon Valley, Tokyo, and New York. Sonya Huang and Deone Leone of Sequoia Capital, one of Silicon Valley's most prominent VC funds, describe Latin America as the "ideal setting for the internet economy to disrupt the real economy." Financial services, e-commerce, health care, and edtech are seen as burgeoning industries. In 2020, for example, fintech startups providing digital financial services entered a multi-year streak as the top sector with the highest amount of capital invested in the region at $1.6 million or 40% of all total capital invested, according to LAVCA.

There is also heightened interest in investing in health and ed-tech startups. Findings released by LAVCA showed that out of 36 health tech and 32 edtech surveyed startups, more than half reported an over 50% increase in product/services utilization during the pandemic.

As VC investment has increased, governments in Latin America have also been approving regulatory changes to enable a more favorable environment for business growth. In 2020 in Brazil, for example, the Senate ratified a legal framework to foster development and boost investments for technology-based businesses. Similarly, in Colombia, a law promoting entrepreneurship was also passed to improve social welfare and equity. It is important to note that six of the region's 33 countries receive the majority of VC deals. The region's biggest startup economies are Brazil, Chile, Colombia, Mexico, Argentina, and Peru. Each of these countries has governments that have created programs to foster entrepreneurship and business development.

Inclusive Technology Opportunity

In contrast with developed markets where disruptive technologies dominate startup ecosystems, Latin American markets and their historic structural inequities present an opportunity for inclusive technology to drive growth. Latin American nations have widespread internet access, yet large shares of their populations are underserved, creating an opportunity for technology-driven, inclusive startups.

Banking is a prime example of this market opportunity, with the World Bank estimating that around half of Latin Americans are unbanked. In 2017, World Bank data showed that this ranged from just under a third of Brazilians to nearly 60% of Peruvians. Major drivers included cost, with 60% of unbanked Brazilians, Peruvians, and Colombians citing it as a barrier, and distance from financial institutions, with 33% of unbanked Brazilians citing it as a barrier. This gap has begun to close with the growth of fintech startups, particularly during the pandemic. But as of 2021 in Brazil, for example, the Locomotiva Institute estimated that approximately 34 million Brazilians are still unbanked or underbanked.

However, robust internet access presents an opportunity in Latin America. World Bank figures from 2019 estimated that over two-thirds of Latin Americans have internet access, above the world average of around 57%. This, combined with Latin America's high urbanization rate — the second most urbanized region in the world at 81%, according to United Nations figures — brings underserved populations in Latin America within reach of tech startups throughout the region.

Thomas Baldwin, a Wharton/Lauder graduate who is senior advisor at Discovery Americas and co-CEO of Kocomo, affirmed that fintech startups can have an outsized impact in the region due to the presence of these inequities alongside strong internet access. The rise of low-cost smartphones alongside a lower cost of serving customers digitally rather than in brick-and-mortar stores enables startups to extend services to previously unreachable or unprofitable consumers. This strengthens the opportunities for investors as fintech startups acquire new customers with less regular competition relative to typical disruptive startups.

International Venture Investors Are Noticing

While local investors were the primary source of capital in the Latin American venture market in the past, since 2017, international investors have turned their eye to the region and have been deploying capital at an exponential pace. Besides Softbank, some other international investors that have been particularly active over 2020 and 1H21, according to LAVCA, include FJ Labs (20

investments), QED Investors (16 investments), Clocktower Technology Ventures (nine investments), Tiger Global (seven investments), and Andreessen Horowitz (three investments).

Latin America has become the destination of choice for many. The U.S. and other developed markets have become increasingly expensive and competitive in venture capital, driving investors to look for other attractive investment geographies. Armaza of Gilgamesh Ventures also attributes the international interest to the success of startups in the region, and the resulting creation of the "unicorn mafia." According to Crunchbase data analyzing companies over the past five years, at least 23 private Latin American companies have crossed the $1 billion valuation threshold (coined "unicorns"). The unicorn companies were from Brazil, Colombia, Mexico, Chile, and Argentina.

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The success of these companies has created a unicorn mafia, which, according to Armaza, is the formation of new startups by former founders and early employees of marquee startups like Nubank and Rappi — the 2018 unicorns that helped bring international attention to Latin America. More importantly, the unicorn mafia has enabled the dissemination of startup know-how across the region, leading to a surge in interest and new talent. Further influenced by fervent local media coverage, young Latin Americans have been encouraged to pursue their own entrepreneurial ventures and join growing startups, fueling the startup and venture capital ecosystem. The influx of talent in product development, engineering, marketing, and other specialties has bolstered international investor perception of the talent pool in the region, increasing confidence in the Latin America growth opportunity.

International investor interest in Latin American venture capital has also translated into investment exits, allowing investors to make meaningful returns. Previously, liquidity had been a key concern for international investors given the long investment period (venture capital investors can expect to stay in an investment for seven to 10 years) and limited exit paths. According to LAVCA, Latin America experienced strong momentum for liquidity events in Q12021, with about $6.9 billion represented in two disclosed transactions. Furthermore, exits have been more diversified over the past five years, with some companies choosing to IPO on American stock exchanges (NYSE, NASDAQ), and others acquired by Latin American, American, or Asian companies. Interestingly, a secondary market for Latin America venture capital deals has also emerged, allowing current investors to sell their interest in a company to another party during the investment period at a predetermined price based on company performance. According to Baldwin, while common in private equity, secondaries were not a Latin America venture market feature and have only emerged due to the burgeoning demand for highly sought-after startups in the region.

Venture Avoids Private Equity Concerns

Venture capital activity continues to be strong globally, breaking previous record investment and fundraising levels. Venture opportunities will likely continue to grow in Latin America even as international private equity investors withdraw from the region. Private equity investment requires a strong local presence and requires most, if not all, investments to succeed due to the lower return targets. Venture capital models, however, rely on a few investments providing outsized returns, which shelter them from challenges in Latin America. The reasoning behind the relative attractiveness of venture capital over private equity in the region can also be attributed to the following: 1) differing approaches to operational involvement and due diligence that enable Latin American VC investment, 2) vulnerabilities to foreign exchange shocks for Latin American PE investments, and 3) greater exit opportunities for VC investments in the region.

To begin with, the venture capital models' typical hands-off approach toward day-to-day operations insulates them from the challenges private equity investors have faced in Latin America. Baldwin articulates the heavy operational involvement that private equity investment requires as a primary challenge for foreign investments in Latin America. Baldwin describes private equity as "a hyper-local business" requiring hands-on involvement with operational decisions to achieve the returns set out in investment

theses. In contrast, venture capital firms can more easily invest from abroad. In investing in a long tail of startups hoping for one or two major successes, venture capital firms do not require a strong local presence to involve themselves in the operations of each of their investments.

Further, this long-tail model reduces the level of diligence and, therefore, nuanced local knowledge required for venture capital investment. Foreign private equity investors often struggle to achieve the level of rigor in local diligence needed, for example, to achieve two to three times MOIC (multiple on invested capital) and 20% IRR (internal rate of return) on each investment over three to five years, the standard benchmark for private equity deals. However, this level of rigor is not required for venture capital firms, and the investment period is longer at seven to 10 years. As venture capital firms cast a wide net searching for potential unicorn startups, they do not need to achieve a high return on each deal. A venture capital fund can be successful having various deals going to zero, but a few returning 20 times or greater MOIC.

Foreign exchange rates compound the challenges faced by foreign private equity without significantly impacting venture capital. Baldwin cites the Mexican peso's loss of about a third of its value from 2015 to 2020 as a particular challenge faced by foreign private equity investors in the country over that period. Even if an investment doubled in value in terms of local currency, the drop in value, relative to the dollar, wiped out much of the returns for foreign investors. Venture capital, however, is more shielded from foreign exchange risk. Baldwin said that because venture capital investors target 20 times or greater return on a small share of their investments, they are less sensitive to foreign exchange fluctuations.

Finally, these opportunities for venture capital investors and challenges for private equity investors self-perpetuate. As foreign private equity firms pull out of Latin America, private equity firms face fewer and predominantly local exit opportunities. In contrast, venture capital investors will continue to find greater foreign and domestic buyers. Additionally, since venture capital deals are more technology focused than private equity deals, they can more easily pursue U.S. stock markets as a form of exit.

Is VC Growth Sustainable?

Investors in the region believe that venture capital investment will prove more sustainable than many prior investment trends in Latin America. For starters, there is a significant runway for untapped growth that does not rely upon foreign trade or monetary policies. With fintech, for example, greater shares of the population can continue to be served by emerging fintech startups, regardless of overall economic performance in the region. Further, the nature of venture capital will better insulate them from foreign exchange shocks triggered by monetary policy challenges previously seen in the region.

Baldwin said he believes that venture capital has "more potential for long-term durability" during a cyclical downturn than other investment types. Venture capital's insulation from potential poor returns from individual investments will better enable firms to weather cyclical downturns. This, in Baldwin's view, will be particularly important in Latin American markets, which, along with other emerging markets, historically are "first to get hit" when downturns begin.

Additionally, the region is well-positioned to continue to innovate due to attractive tailwinds of increased internet and smartphone penetration, growing middle class, deepening local talent pool, startup-friendly regulation, and other government initiatives. All of these developments should support ongoing entrepreneurial and investment activity.

Like any type of investment, venture capital in Latin America still holds risks, particularly geopolitical in many countries in the region. However, the region is prime to be transformed by inclusive technologies at potentially attractive returns, leading to a bright future outlook for this investment class.

This article was written by Stephanie Michael Silva, Mariam Badi, and Billy Thomas, members of the Lauder Class of 2023.

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