

# High growth companies and how to fund them – a real driver of economic growth?

**Corporate Acquisitions and Joint Ventures Commission**

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## **National Report of Brazil**

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The working session in Prague is entitled “*High growth companies and how to fund them – a real driver of economic growth?*” In the working session we plan to address funding alternatives for high growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high growth companies. This questionnaire mainly concentrates on these two topics in relation to high growth companies, but will also cover commercial and regulatory opportunities and constraints.

## 1. CORPORATE FINANCE – FUNDING ALTERNATIVES

### 1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

Most of the investments in high growth companies in Brazil are made through equity transactions, upon issuance of preferred stock to the investor. Equity deals are made when the investor already has a certain level of trust in the business and its profitability in the future, as the investor will become a shareholder and share the risk of the business with the other shareholders/founders.

However, when an investor is not sure about the viability and profitability of the business, or simply does not want to be a shareholder at any given moment, such investor may want to invest through debt transactions (*i.e.*, investor does not share the risk of the business), with a possibility of further converting the debt into equity in the company. Debt deals are usually simpler (as regards to the documents and negotiations) if compared to equity deals.

### 1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

Please refer to the answer of question 1.1. above, which already details the pros and cons.

### 1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

There are no constraints itself, but there are certain legal issues that must be observed, such as, without limitation, (a) the registrations of foreign investments and foreign loans transactions with the Brazilian Central Bank system; (b) the limitations of applicability of interest rates in Brazil, which are generally limited to the official rate charged by the Central Bank of Brazil for non-financial institutions (*e.g.*, generally an investor in a debt transaction may not apply interest on the loan to the borrower at a rate higher than that rate which currently is 10.75% per year); (c) restrictions imposed by Brazilian Law for foreign investment in certain sectors, i.e. there are certain sectors in which the business may be performed only by native or naturalized Brazilians or participation is prohibited to foreign investors (or limited to a certain percentage of equity interest), such as, for instance: health/medical assistance, media companies, aviation, nuclear energy, among others; and (d) thin capitalization rules.

Additionally, it is important to mention that any foreign investors in a Brazilian company must previously obtain their registration with the National Taxpayer Registry for Corporate Entities (“*Cadastro Nacional de Pessoas Juridicas*” – CNPJ) or the National Taxpayer Registry for Individuals (“*Cadastro Nacional da Pessoa Física*” – CPF), as the case may be, as well as with the Brazilian Central Banks’s electronic registration system (“*Cadastro de Empresas do Banco Central do Brasil*” – CADEMP). In addition, such foreign investors must appoint a Brazilian resident individual or a foreigner holding a permanent visa to act as their attorney-in-fact, with powers to, among others, receive summons of process on their behalf.

Upon the registration of their investment with the Central Bank (which is a quick procedure), foreign investors will be able to remit abroad dividends, as well as repatriate their investment made in Brazilian companies.

Cross-border loan transactions shall also be registered with the Central Bank of Brazil through the ROF mechanism (Financial Transactions Registration) prior to the entry of the relevant funds into Brazil. The ROF registration is a declaratory electronic registration which shall be made by the Brazilian borrower through the Central Bank electronic system informing the terms and conditions of the loan transaction, including principal, interest, term, fees and commissions. Upon entry of the relevant funds into Brazil, the schedule of payments of the ROF registration shall be validated so that any payments of principal and interest may be made by the borrower to the foreign creditor (that is, the foreign exchange contract is linked to the ROF registration).

#### **1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.**

Crowdfunding is an alternative in Brazil, but not yet adequately explored. According to the applicable regulation enacted by the Brazilian Securities Exchange Commission (“CVM”), a distribution of shares of a small company in an amount lower than R\$2,4 Million is exempt from registration with the CVM, and crowdfunding may be included within such exceptions. However, as there are no specific rules for crowdfunding in Brazil, such mechanics is not very explored by start-up companies in Brazil. Note, however, that CVM is currently studying several alternatives in order to facilitate the access of start-ups to the Brazilian capital markets and crowdfunding mechanics may be included in a specific regulation in a near future.

## **2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL**

### **2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)**

The typical investors in high growth companies in Brazil are as follows:

- Angel investors: Individuals investing from USD\$25,000.00 to USD\$250,000.00 in each high growth company;
- Seed Capital (this stage, which is the first level of the “venture capitalists”, the investors are already in the form of funds or specific purposes companies), investing from USD\$250,000.00 to USD\$1,000,000.00 in each high growth company;
- Venture Capital (all types of specialized venture capital funds) investing from USD\$5,000,000.00 to USD\$20,000,000.00 in each high growth company; and
- Private Equity Funds, higher investments in companies which might be close to launching a public offer or investing in companies that are already publicly-traded.

### **2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?**

Please refer to the answer of question 2.1. above.

### **2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)**

The first document supporting an investment would be the term-sheet (which may also be called a letter of intent or a memorandum of understanding), which has to briefly outline the terms and conditions of the investment. Usually, a non disclosure agreement is also executed between the parties. After the due diligence, as the case may be, the formalization of the transaction would typically include the execution of (a) a Subscription or Investment Agreement; (b) a Shareholders’ Agreement; (c) Proprietary Information and Assignment Agreement; (d) Management Agreement; and (e) Corporate Acts of the company approving the capital increase and issuance of shares, among others (Minutes of Special Shareholders’ Meetings).

A venture capital deal in Brazil would typically be structured with the issuance of preferred stock with voting rights to the investor (while founders usually hold common stock), and the general terms and conditions of the transaction would include – without limitation - the following provisions:

- Preferred stock convertible into common stock at any time (the conversion ratio initiates in a 1:1 ratio, but in case of certain corporate events, the conversion ratio would be modified in order to protect the preferred shareholders against dilution – anti-dilution provision);
- Automatic conversion of preferred stock: In case of occurrence of certain events such as an IPO of the company;
- Anti-dilution provisions: As mentioned above, generally consists of adjusting the conversion ratio of the preferred stock upon the occurrence of certain corporate events (there are several types of anti-dilution provisions, including *full ratched antidilution* and *weighted average antidilution*);
- Possibility of redemption of the preferred stock by the investor (after a determined period (*e.g* 7 years from the investment). Such provisions “guarantees” that the investor will recover at least the original amount invested;
- Liquidation preference (preferred shareholders receive funds in priority to the holders of common stock in case of liquidation events);
- Participating preferred stock (after the liquidation preference, as mentioned above, the holder of preferred stock receives funds *pro-rata* to its equity in the company in case of occurrence of a liquidation event, on a “as converted” basis);
- Subsequent series of investments: liquidation preference rights *pari passu* with the prior series of investments;
- Preference to receive declared dividends (although usually a start-up company does not declare and distribute dividends);
- Granting of stock options to employees;
- Veto rights depending on the matter to be decided by a shareholders’ meeting;
- Installation of a Board of Directors with at least one representative of the investor;
- Registration rights: Upon certain circumstances the holder of preferred stock may require that the company performs its registration in a stock exchange;

- Information rights: holder of preferred stock has the right to receive of sorts of information from the company (business, legal, financial etc.);
- Co-Sale or Tag-Along rights (joint sale in case of sale of stock to third parties); and
- Drag-Along rights (preferred shareholder may force the founders, under certain circumstances, to sell their common stock to third parties).

**2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?)**

There are no specific incentives from the government for investing in high growth companies in Brazil. The government has, however, developed certain programs created with the purpose to promote and finance innovation and the scientific research in companies, universities and even the government itself. One example of such programs is the *Financiadora de Estudos e Projetos – FINEP* which is related to the Ministry of Industry and Development. The Brazilian Bank of Social and Economic Development may invest in high growth companies through investment funds as well.

**2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?**

As mentioned above, usually investments in high growth companies in Brazil are made through equity transactions and the investors (whether domestic or international) generally require the terms and conditions listed in item 2.3 above.

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| <p><b>3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL</b></p> |
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**3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)**

The most popular form of company (for small and medium sized companies) in Brazil is the limited partnership (*sociedade limitada*) regulated mainly by the Brazilian Civil Code (Federal Law No. 10,406/2002).

However, when a company is ready to receive an investment, investors generally require that the company is in the form of a corporation (*sociedade por ações*) as regulated by Federal Law No. 6,404/1976 (Brazilian Corporations Law), which is

a more adequate form for companies with multiple shareholders or investors, as it provides and regulates corporate structures of higher complexity and provides for several rights and protections to the company, its management and the shareholders.

Both types of companies basically enjoy the same tax treatment, nevertheless the costs implied in the set up of a limited partnership are less significant, and expenses with publications of corporate documents and financial statements may be waived, thus enhancing confidentiality as to corporate affairs. Additionally, limited partnerships are more flexible types of company, since their articles of association can be drafted more freely and in line with the expectations of the partners.

**3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?**

In Brazil, high growth companies are mainly concentrated in the technology sector, therein included social media networks and platforms for rendering of services through tablets and smartphones. Also, due to the upcoming FIFA World Cup and Olympic Games, the hospitality sector (including hotels and tourism) has been receiving significant investments.

**3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g accelerators/incubators? Other?)**

There are several private accelerators and incubators for high growth companies in Brazil, and they work to provide support aiming the continuing growth of the company and potential investments in the company by angel investors or venture capital funds.

**3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?**

There is no specific preference, it basically depends on a case-by-case analysis, whereby the entrepreneur should decide and approve the valuation of the company before the performance of the investment and the consequent dilution of the founder. Depending of the negotiations and other specific circumstances, the founder may otherwise decide to be financed through a debt transaction, as opposed to an equity transaction.

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| <b>4. CORPORATE GOVERNANCE – CONTROL ISSUES</b> |
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**4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:**

- a. Anti-dilution measures
- b. Rights of first refusal, pre-emption rights, drag and tag along
- c. Protective provisions
- d. Information rights
- e. Dead-lock resolution
- f. Board seats / observer rights
- g. Any other terms specific/important in your jurisdiction?

Please refer to the answer of question 2.3. above.

## **5. EXIT STRATEGIES AND TIME HORIZON**

**5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?**

Typically, an exit may occur through the sale of stock to an international investor (private equity or venture capital fund). There are several cases of exits occurring through sales between the PE and VC funds. An example of a success exit strategy may be an exit through the performance of a secondary public offering of the company with the PE or VC fund being the selling shareholder.

**5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?**

New investors will usually require all the contractual protections and rights mentioned above (see item 2.3), and such terms and conditions are generally accepted by the entrepreneur/founder. The valuation of the company is always a major issue of the negotiation; as such aspect will ultimately define the percentage of the dilution of the founder of the company upon consummation of the investment.

When new rounds of investments with other investors occurs, a new set of documents should be executed by the respective parties, but generally such documents are prepared based on the agreements related to the previous rounds, and all series of investments should be *pari passu* among them as regards to their terms and conditions. However, note that the similarity of terms and conditions between the rounds is a negotiable matter, and new investors may require additional/incremental rights or in preference to the rights in connection with the previous rounds of investments.

## **6. REGULATORY ISSUES**

### **6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?**

There are no specific tax implications to a high growth company in Brazil, whereby such company would be subject to the general tax rules applicable in Brazil. Note, however, that in Brazil any company with a gross of up to USD\$35,000,000.00 may enjoy certain benefits and choose to calculate and collect its income tax (IRPJ) and contribution on net profits (CSLL) according to the presumed profits (*lucro presumido*) system, which is utilized in order to presume the profit of the company in light of its effective gross income. Such system simplifies the calculation and lowers the effective amount of taxes to be levied by the benefited companies.

### **6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.**

No. Regarding local participation, please refer to our comments to item 1.3 above.

## 7. OTHER

### 7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

Brazilian Law number 12,529/2012 (“Brazilian Competition Law”), which is effective as from May 29, 2012, regulates competition in Brazil and establishes rules concerning the abuse of a dominant position. The Competition Law lists those anti-competitive practices that may constitute a breach of the economic order, and, therefore, could have an impact on the envisaged corporate transaction.

Brazilian Competition Law stipulates, in its Article 36, the acts performed by the economic agents and their effects, which shall be considered as violations of the economic order.

*Article 36 Notwithstanding malicious intent, any act in any way intended or otherwise able to produce the effects listed below, even if any such effects are not achieved, shall be deemed a violation of the economic order:*

*I - to limit, restrain, or in any way injure open competition or free enterprise;*

*II - to control a relevant market of a certain product or service;*

*III - to increase profits on a discretionary basis; and*

*IV - to abuse one’s market control.*

Anticompetitive practices are characterized as such only in the event that they are likely to unjustifiably limit competition, concentrate economic power, dominate markets, arbitrarily increase profits or impose abusive practices. In light of the above, the Administrative Economic Protection Council (“CADE”) considers specific aspects such as the peculiarities of the business, the product or service involved, the size of the market, the commercial sector and the nature of the transaction.

The Brazilian system of antitrust control controls anti-trust behavior from the standpoint of the public interest. CADE may order some actions to be undone and impose measures to be taken by the infringing party or impose administrative sanctions, which includes monetary penalties.

As stated in Article 2 of Brazilian Competition Law, *'Without prejudice to any agreements and treaties to which Brazil is a party, this Law applies to acts wholly or partially performed within the Brazilian territory, or the effects of which are or may be suffered therein.'* Thus, rules arising from the Brazilian Competition Law shall be applicable to acts practiced in Brazil or acts that might have effect in Brazil, as well as to companies that operate (have a subsidiary, a branch, an office, an establishment, an agent, or a representative located in Brazil). If the transaction is not completed in Brazil but produces effects in Brazil, it shall be governed by the Brazilian Competition Law.

Competition Law, as further detailed by Joint Ministerial Ordinance no. 994, dated May 30, 2012, stipulate that the parties must submit to CADE any and all arrangements for concentration acts in which (i) one of the participants is part of a commercial grouping that has a gross annual turnover of or a total volume of transactions amounting to R\$750 million (currently approximately U.S. \$320 million) or more in Brazil, in the year before the respective arrangement, **and** (ii) the other participant is part of a commercial grouping that has a gross annual turnover of or a total volume of transactions amounting to R\$75 million (approximately U.S. \$32 million) or more in Brazil, in the year before the respective arrangement. As established by the Competition Law, the following are considered arrangements for market concentration<sup>i</sup>:

- (1) merger of independent companies;
- (2) direct or indirect acquisition of the control or a portion of a company, by means of purchase or barter of equity participation, titles, convertibles securities or tangible or intangible assets;
- (3) one or more companies merged into another; or
- (4) two or more companies enter into any kind of affiliation or partnership, consortium or joint-venture agreements.

The purpose of submitting such transactions to the antitrust authorities is to allow an analysis of whether the transaction modifies or could potentially modify the market's structure or may produce negative effects on social welfare as a result of the elimination of competition.

If a concentration act is consummated before the approval of CADE, it shall be liable to invalidation and fines shall be applied in the amount of approximately BRL 60,000.00 (60,000 Brazilian Reais) to BRL 6,000,000.00 (6 million Brazilian Reais), depending on several aspects, such as, for instance, the good faith of the parties involved, their economic situation, the damages to the market.

The CADE, in its decision, will assess the existence of potential anti-competitive effects arising out of the transaction under analysis and can either approve the transaction in full, approve it with the imposition of conditions (divestments,

guarantees of employment, licensing of patents or trademarks), or reject the transaction in full, ordering its undoing.

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<sup>i</sup> (Articles 88 and 90 of the Competition Law)