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Q2

THE NEW NORMAL OF VENTURE CAPITAL

Introduction

In recent years, especially in 2020 and 2021, investment round amounts and valuations have been rising globally. In Brazil, this is due in large part to a maturing ecosystem, but also because of the entry of international players, and, in addition, Private Equity firms have been participating in earlier stages, such as Series A and B rounds.

Among the global players, Tiger Global Management stands out (in Brazil, its investments include Loft, GetNinjas, Cora and Vtex), which, with its strategy of "playing a different game", has been disrupting the market and leaving traditional Venture Capital ("VC") funds behind, by providing more capital and, of course, higher valuations.

Fuse Capital ("Fuse") aims to differentiate itself from traditional Venture Capital precisely by positioning itself as an alternative illiquid house that looks for asymmetries in the market and creates products that fit them. This is the case of its Fuse Capital I fund, the first hybrid (equity and non-convertible debt) early-stage VC fund in Brazil.

The hybrid fund was the beginning of Fuse's innovation trail, which currently already has three other differentiated products. These are just the first of many innovative and disruptive products that we are developing, thus, providing a Venture Capital model ahead of the current one.

"Whosoever desires constant success must change his conduct with the times."

Nicolaus Machiavelli

Seed rounds, it seems, are still protected from such statement, with values remaining stable and local funds still very active, as they are willing to provide a more hands on approach.

But with late-stage funds venturing into earlier rounds (Series A and B), early-stage funds now have to offer differentiated products and services to, thus, reach distinct niches.

Global Scenario: Coronavirus, the Black Swan of 2020?

From 2016 to 2020, global investment in startups, according to CB Insights Ventures (Report Q2 2021), doubled and surpassed the impressive $300 billion mark. In fact, between 2019 and 2020 alone the increase was 14%. This, however, was not the expected scenario.

In March 2020, an article entitled "Coronavirus, the Black Swan of 2020" was published by Sequoia Capital, which compared the expected scenario for the short term with that post-crisis of 2008. In the paper, the authors stated, "We didn't know then, just as we don't know now, for how long or how sharp or shallow the recession we will face will be."

The paper reflected a perception of insecurity and concern about expectations in the Venture Capital world, more specifically, a fear about the coming recession that would affect the world of startups.

As we move towards July 2021, we find ourselves in a different reality from the one pointed out, with investors becoming nimbler and more willing to take greater risks in the sector. In the first six months of 2021 alone, according to data from CB Insights Ventures, $292.4 billion was invested, a very significant number, especially when compared to the total amount of $302.6 billion invested in 2020.

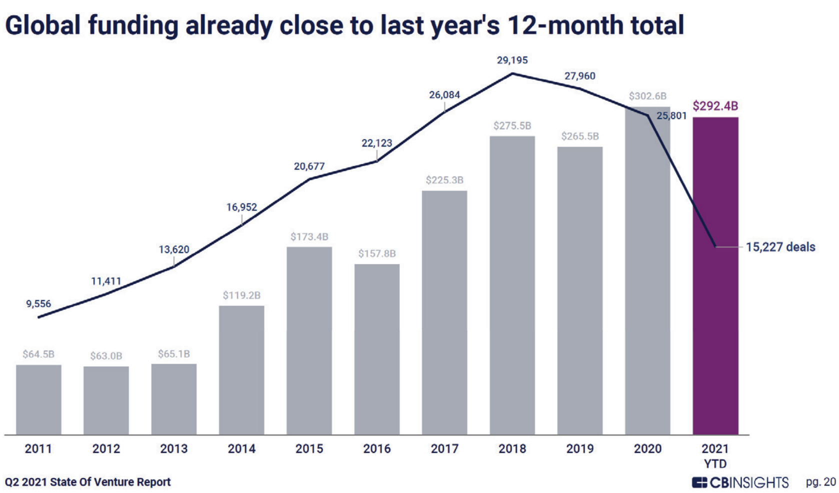
What are these extraordinary numbers due to?

For Fuse, the increase is the result of the conjunction of two factors: great liquidity in the market and the enormous digitalization of entire economies, which originated, paradoxically, from the very tragedy of the pandemic, and ended up determining the need for companies to adopt new technologies, with innovative business models and unprecedented consumer behaviors.

Added to the above factors is the success that the cloud applications space has achieved in recent years, making it possible to elaborate on various ideas that, until then, were hindered by their high cost of implementation. This was reflected, in particular, in the increase in mega-rounds, investments greater than $100 million, which this year alone gave rise to 249 new unicorns (CB Insights, Q2 2021- State of Venture Report).

Simultaneously, the increase of exits in IPOs of companies, backed by Venture Capital, gave a new impulse to the market, due to tangible mediums of liquidity for investors.

Given this reality, we can affirm that the strong performance of the public markets in technology, together with the record amounts raised by startups, points to a scenario of an increase in the pace of funding for 2021 and the following years. This global scenario is also being reproduced in Latin America, with special emphasis on Brazil.



Brazil: “It’s a story about talent, not money.”[1]

A decade ago, despite holding one of the highest internet penetration rates in the world and being home to a rising middle class, Latin America had a dismal startup ecosystem, with founders importing ideas from the United States without considering whether they would, in fact, have a local application or without having sufficient technical capacity themselves to exploit them (“The Latin American Startup Opportunity,” Sequoia Capital).

Six months into 2021, we find Latin America breaking records in Venture Capital activity, reaching $9.3 billion in funding (“Q2 2021 State of Venture Report”, CB Insights).

In Latin America, Brazil is the big leader in venture asset investments, raising more than 50% of the total amount, with over $5.6 billion to date, a 334% increase over the same period in 2020. We arrive, then, to Brazil “in 2021 with the ecosystem proven, mature and with a lot of liquidity”.

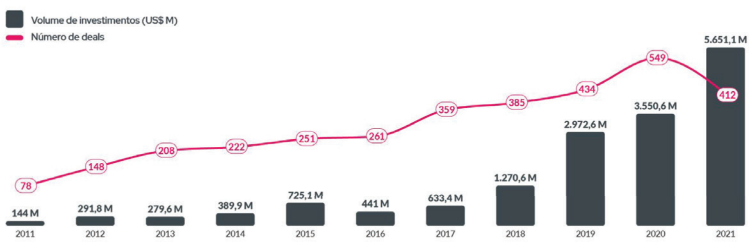
This maturing ecosystem, therefore, has attracted global players. Regarding it, Sequoia Capital stated:

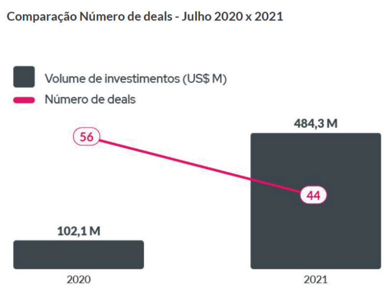
> “We have been blown away by the quality of founders in the current wave. They have struck us as having large-scale ambition, strategic thinking, a tight grip over metrics, operational excellence, and infectious energy and passion for what they are building.” (“The Latin American Startup Opportunity”)

This heated scenario occurred due to a few factors, among which, we highlight:

> (a) Growing availability of capital: in the last decade, an unprecedented interest rate drop was observed in Brazil, with the SELIC reaching 2% p.a. in 2021, a number never seen in the country (recently, the rate has been high, but is at low levels for our standards). Under these circumstances, Brazilians, who until then were used to very high average rates, found themselves obliged to look for alternatives for investing their funds, as a way to obtain better yields than those resulting from the fixed income market. In this search, investors saw in the Venture Capital market an opportunity to increase profits, even if accompanied by higher risks and lower liquidity.

Evolução de investimentos de VC no Brasil
2011 - 2021





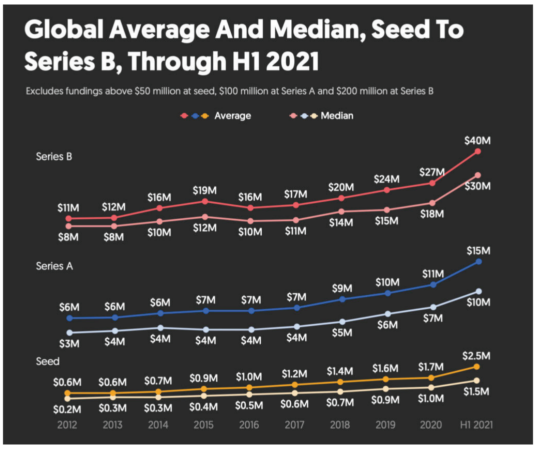
1. HEIM, Anna & WILHELM, Alex. “Why Latin American venture capital is breaking records this year”, TechCrunch, Jul. 2021.
2. RODRIGUES, Romero, “Venture Capital no Brasil: como chegamos até aqui e o que vem daqui pra frente”, Redpoint eventures.

(b) Maturing of the innovation and Venture Capital ecosystem: the success of startups such as Nubank, Loggi and Quinto Andar drove a new generation of entrepreneurs, young people who decided to go into the innovation market and no longer to the corporate market. Added to this is the return of serial entrepreneurs who have already built their businesses and have returned to entrepreneurship faster and more efficiently. The result? In 2021, in Brazil alone, there were three new unicorns (MadeiraMadeira, Mercado Bitcoin, and Unico).

In fact, we are witnessing a fast-growing market, with maturing fundamentals and late stage and global funds coupled with success cases and liquidity events. There is no doubt that there are many opportunities in Brazil. Big global players have already seen this chance and have been acting on it.

The New VC Game

The reality shows that the investments are bigger and the space between them shorter, which is a global trend reflected in the increase of the value of the rounds.



What has led to this increase?

As mentioned, the new strategies that are being implemented by players originally focused on the growth market, such as Tiger Global Management ("Tiger"), which has invested in about 118 startups by the beginning of June 2021 alone, according to Crunchbase, has drawn our attention.

In the recently published article "Playing Different Games," author Everett Randle described Tiger's aggressive strategy on the global stage, which focuses on "maximum implementation speed," i.e., investing as quickly as possible the amount raised, coupled with "better/faster/cheaper capital for founders." Tiger's strategy can be summarized as:

- "Be (very) aggressive in pre-empting good tech businesses
- Move (very) quickly through diligence & term sheet issuance
- Pay (very) high prices relative to historical norms and/or competitors [up to 20% more, thus providing more money for less dilution]
- Take a (very) lightweight approach to company involvement post-investment

- Above all, deploy capital, deploy capital, deploy capital"

This strategy is not limited to Tiger's performance, and reflects an increasingly competitive market for the search for the next unicorn, with funds entering early-stage rounds and with higher contributions. Following this line of thought, Series B funds onwards realized that missing out on the first rounds of investment in startups would probably mean paying too much in the future or not getting the chance to enter at all, so they started investing in earlier rounds.

In Brazil, from the end of 2020 to the end of the first half of 2021, the average value of Series A and Series B rounds increased by 17.5% and 40% respectively, reaching $9.4 million and $34.8 million. The average seed funding, on the other hand, remained more stable, staying between $1.1 and $1.2 million over the same period (Report Inside Venture Capital, Wrap up,2020 and Jun/2021. District).

As pointed out by Distrito (Report Inside Venture Capital, first half, 2021), in Brazil, although 70% of the investments were concentrated in the early-stage (angel, pre-seed and seed), 95% of the volume was invested in the late-stage. This shows how mature the Brazilian market is, but also points to an important fact: there is a high concentration of capital in mega-rounds, concentrated in a few late-stage deals.

The seed rounds, it seems, are more protected, with more stable investment and valuation values. In large part this is because entrepreneurs expect a more hands-on approach and more time from the investors with their business.

The feeling of protection leads a large number of Brazilian early-stage funds to simply follow the probabilistic model of scaling up, investing in countless startups with little to no hands on (some invest in as many as 25 startups a year). This model, however, is not the most efficient for the Brazilian market, which is less mature and less liquid when compared to the US market.

With more late-stage funds investing in earlier rounds, it is evident that it is essential that Venture Capitals focused on the early stage offer differentiated products and services and act in niches. This is what Fuse Capital has been specializing in.

" Without change there is no innovation, creativity, or incentive for improvement. Those who initiate change will have a better opportunity to manage the change that is inevitable."

William Pollard

Fuse Capital: creating its own game in the world of VC

In order to distance ourselves from the market hype and high valuations, we positioned ourselves as a house of niche alternative products. In this way, Fuse "creates its own game" in the VC world, as it did with the Fuse Capital I Fund product, the first hybrid early-stage Venture Capital fund in Brazil.

With this innovative creation, Fuse can choose to invest in a startup either in (i) equity, i.e., participation in companies that we see potential and can promote a collaborative hands-on management; or in (ii) Venture Debt, which in practice represents a structured non-convertible debt (with guarantees) for technology-based companies that need capital but are not raising capital at the moment and/or do not want to be diluted.

With regard to Venture Debt, we can make a comparison with Tiger's innovative strategy, since this financing model can be offered at any time. In addition, it is a faster, cheaper, more efficient and scalable product for certain startups because:

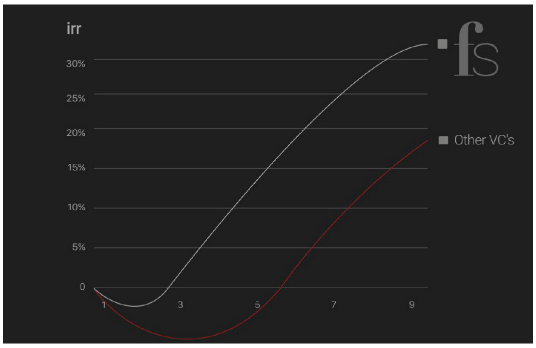
- it is a cheaper capital, the cost is limited to pre-set rates;
- it is paid back over time and with interest;
- the due diligence process is less intense than it would be in equity rounds;
- investors do not need to be hands on, as no equity is taken;
- results in lower duration returns than the average in the VC market;
- enables Fuse to approach startups without an open round, but that are interesting for eventual equity investment.

The big difference with Venture Debt is that there is no dilution of the entrepreneurs' participation, since it is a debt that does not convert. It is, therefore, an attractive and less risky alternative. After all, while investors in equity make claims on the future value of the startup (at the expense of diluting the entrepreneurs), in debt claims are made only on the future cash flows until the debt is repaid, as previously agreed between the parties (PitchBook Analyst Note: Venture Debt a Maturing Market in VC, 2020).

> *"You cannot solve a problem at the same level at which it was created. You have to be above it, moving to the next level. "*
>
> Albert Einstein

But it's not just on the entrepreneur side that Fuse innovates with this product. On the investor side, a hybrid fund with Venture Debt and Venture Capital solves major difficulties of Venture Capital: liquidity and allocation of its investors' money. After all, debt generates an annual yield for the investor.

With the hybrid fund, we created a risk and return profile quite different from the existing solutions in the Brazilian market, and the funding strategy of 70% equity and 30% debt has already proven successful. The "J Curve", which normally reflects the reward in an equity fund, does not present this steep curve when there is an optimal portfolio mix, as shown in the chart below:



Expected irr curve over time of the fund

This solution was just the beginning of Fuse's innovation trail, which currently has three other differentiated products, as we mentioned earlier. After all, as author Chris Grosser said, "opportunities don't just happen, you create them".

This was the case with the co-investment option offered by Fuse to its Limited Partners in pre-IPO and late-stage deals, created from a proprietary pipeline derived from the partners' decades of exposure to the Brazilian financial market and to the global VC market.

This exposure to the capital markets also gave rise to the Venture Capital as a Service (VCaaS) program, with which Fuse helps large corporations with their digital transformation by connecting and directing their investments to startups they perceive as strategic. Meanwhile, they provide Fuse with the opportunity to add value to their investees, with partnership possibilities.

For the investor, another innovation was Securitized Token Offerings (STO), a way to make Venture Capital product liquid by tokenizing it from an offering of equity or debt securities of a private company on a global exchange (If the topic interests you, we recommend reading our Quarterly Letter Q1/2021).

Fuse, as demonstrated, is the house of niche alternative illiquid assets. The hybrid fund and the other opportunities described are just the first of many innovative and disruptive products being developed. Fuse, thus, aims to provide a Venture Capital model ahead of the current one.

" Expect change. Analyze the landscape.
Take the opportunities. Stop being the chess piece;
become the player. It's your move."

Tony Robbins

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"From entrepreneurs to entrepreneurs"