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The Andean Death Valley: Are Latin American Entrepreneurs Destined to Fail?

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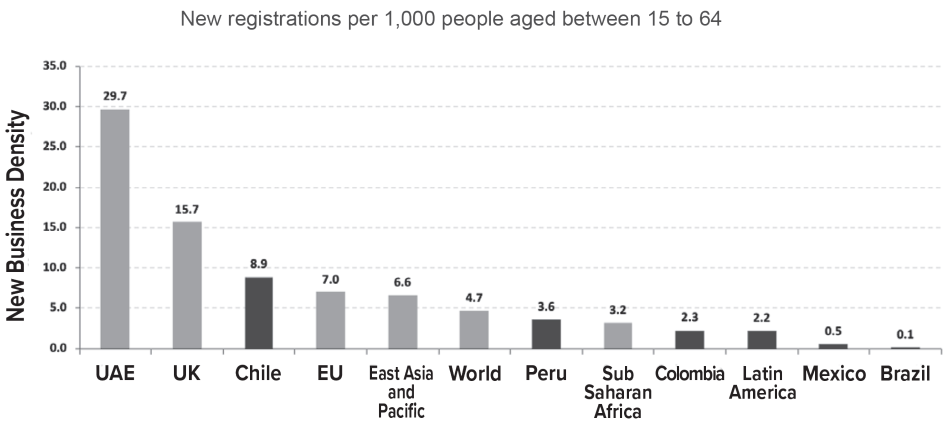
The benefits of entrepreneurship[1] are indisputable.[2] Start-ups were responsible for all net new job creation in the United States from 1977 to 2005.[3] The same trend holds in emerging markets. According to the World Economic Forum, small and medium-sized businesses, which are a widely accepted proxy for entrepreneurial activity, accounted for 97 percent of all formal jobs in emerging economies in 2013.[4] The Global Entrepreneurship Development Institute argues that improving the global conditions for entrepreneurship by 10 percent could add US $22 trillion to the global economy.[5] The correlation between entrepreneurial activities and economic growth is difficult to dispute.

Despite the multiple benefits of entrepreneurship, Latin America's entrepreneurial ecosystem is still lagging behind. Figure 1 shows the World Bank's new business density indicator for various countries and regions of the world.[6] In Latin America and the Caribbean, there are 2.2 new companies for every 1,000 working-age people, which represents less than half of the global average, ranking the region behind Sub-Saharan Africa.

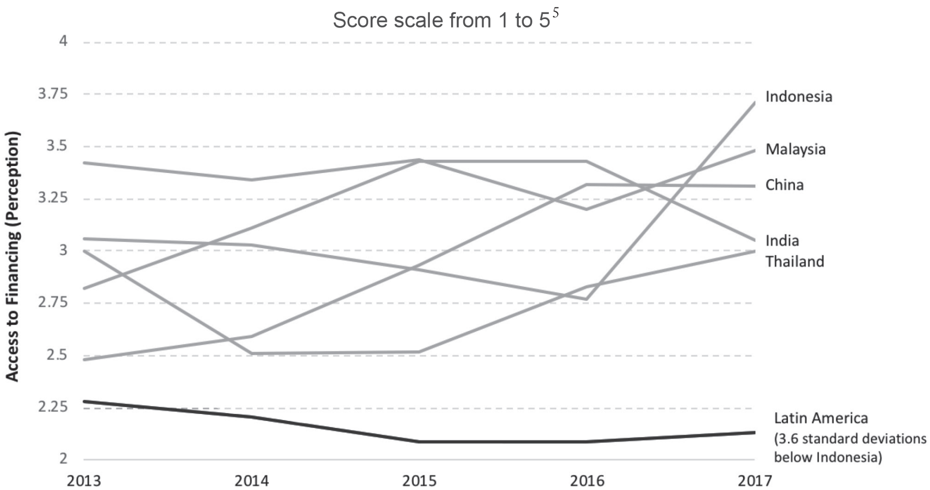
That said, it is crucial to understand what is behind the region's inability to promote entrepreneurship. The Global Entrepreneurship Monitor (GEM) measures and tracks the factors that determine the ease of starting a business in different economies. In its 2017 survey, entrepreneurs in Latin America ranked the availability to financial resources as the lowest variable tracked by the GEM.[8] It is worth noting that entrepreneurship education and research and development transfer also ranked very low. Figure 2 shows entrepreneurs' perception of access to finance in various developing economies. The average

Figure 1: New Business Density (2016)



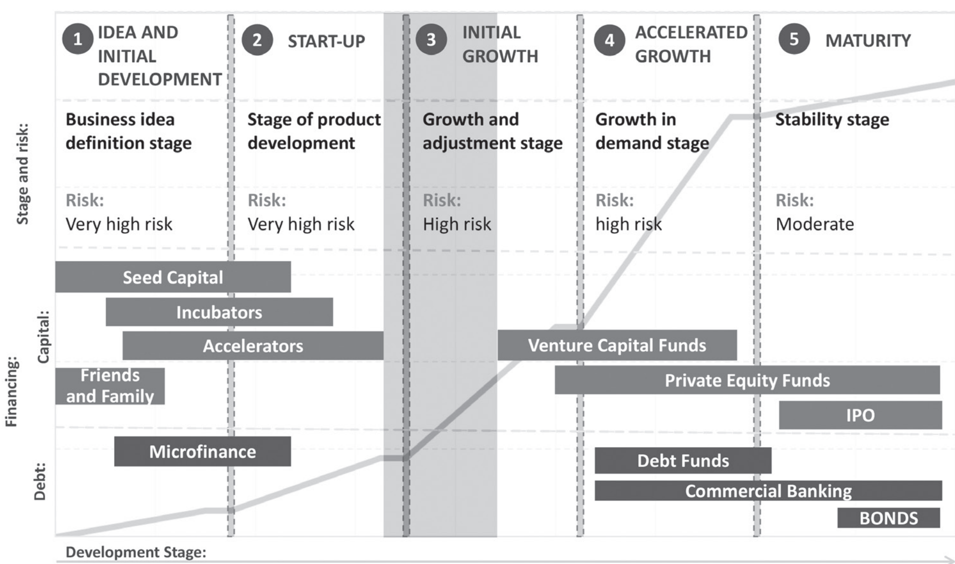
Source: The World Bank, 2016

Figure 2: Perception of Access to Financing (2013-2017)



Source: GEM

Figure 3: Venture Stages and Financing Resources



Source: Analysis of the Author

for Latin America is 3.6 standard deviations below Indonesia (the highest-ranked country). This suggests that the scarcity of financial resources plays an important role in the limited success of entrepreneurial activity in the region.

Figure 3 shows the financial resources typically available for each stage of development of a new venture. The expected capital path of a new venture is to receive capital from a venture capital firm after being accelerated in its start-up stage (Stage 2). Some researchers argue that there is an apparent disconnection in the capital available for a venture when it is transitioning from the start-up stage to initial growth (Stage 3). This is known in the venture capital industry as "Death Valley."

Is there enough evidence to argue that there is a Death Valley between the accelerators and the venture capital industries in Latin America? If so, what is its magnitude and implications?

Figure 4 summarizes the capital deals for accelerators and venture capital funds in the region. In 2016, Latin American accelerators and incubators invested over $24.2 million in 1,795 start-ups, representing an annual increase of 26 percent compared to the number of investments in previous years.[10] The Latin American Private Equity and Venture Capital Association (LAVCA) reported 197 venture capital investments totaling $501 million for 2016.[11] The average investment by accelerators in the region was approximately $13,500, while the average investment for the venture capital industry was $2.5 million. This means that an accelerated startup needs to grow organically – or with debt, which is not easily accessible to companies that have not shown a sustained inflow of revenues – to scale up to a size where they can receive an average capital investment of at least $2.5 million.

Based on these numbers, the average investment of a venture capital firm is 185

Figure 4: Accelerators and Venture Capital Investments in Latin America - 2016

Source: Compilation by the author based on LAVCA, 2017 and Gust, 2016[12] times the average investment received with an accelerator in the previous stage of development (Stage 2). This partially explains why many firms can't survive this stage of growth, suggesting the existence of a gap between the start-up stage (Stage 2) and the scale-up stage (Stage 3): namely, *the Andean Death Valley*.

The lack of fluidity of the capital available to support and promote the entrepreneurial ecosystem in Latin America is condemning entrepreneurs to failure. The high-risk nature of the investments is misaligned with the capital requirements and expected returns for private funds. This market failure is jeopardizing the success of a cohesive and thoroughgoing capital cycle that creates conditions for venture survival and growth in the region. It is therefore urgent for Latin American governments to create policies to close this gap. The governmental institutions that foster entrepreneurship should aim to create financial mechanisms and fiscal incentives to generate capital opportunities to scale up, and therefore ensure the survival of new ventures.

NOTES

[1] Entrepreneurship can be defined as the process of designing, launching, and operating startups, beginning with turning an innovation into a sustainable business, through a solid product market fit and a viable business model. Many organizations also include small businesses in their definition of entrepreneurship.

[2] Steve Ciesinski and Ryan Kissick, "A Note on Entrepreneurial Ecosystems in Developing Economies," Stanford Graduate School of Business case no. E611, 2016, https://www.gsb.stanford.edu/faculty-research/case-studies/note-entrepreneurial-ecosystems-developing-economies.

[3] Tim Kane, "The Importance of Startups in Job Creation and Job Destruction," Kauffman Foundation, July 2010, https://www.kauffman.org/what-we-do/research/firm-formation-and-growth-series/the-importance-of-startups-in-job-creation-and-job-destruction.

[4] "Entrepreneurial Ecosystems Around the Globe and Company Growth Dynamics," World Economic Forum report, September 2013, http://www3.weforum.org/docs/WEF_EntrepreneurialEcosystems_Report_2013.pdf.

[5] Zoltán Acs et al., "Global Entrepreneurship Index 2017," The Global Entrepreneurship and Development Institute, 2016.

[6] New registrations per 1,000 people ages 15-64. Source: "Doing Business," World Bank, June 2017, http://www.doingbusiness.org/data/exploretopics/entrepreneurship.

[7] GEM's NES questionnaire tracks entrepreneurs' perceptions related to Entrepreneurial Finance, Government Policy, Government Entrepreneurship Program, Entrepreneurship Education, R&D Transfer, Commercial and Legal Infrastructure, Entry Regulation, Physical Infrastructure, and Culture and Social Norms. See GEM, http://www.gemconsortium.org/.

[8] GEM, "Entrepreneurial Framework Conditions," http://www.gemconsortium.org/data/sets?id=nes.

9 In the GEM survey, entrepreneurs and experts are asked about the availability of financial resources (equity and debt) for small and medium enterprises (SMEs) (including grants and subsidies). The scale is 1 to 5, where 1 means the statement is completely false (very low or nonexistent availability for financial resources), according to the expert; and 5 means the statement is completely true (high availability of financial resources).

10 GUST, "Latam Accelerator Report 2016," http://gust.com/accelerator_reports/2016/latam/.

11 LAVCA, "2017 Trend Watch: Latin American Venture Capital," https://lavca.org/industry-data/trend-watch-2016-latin-american-venture-capital/.

12 GUST, "Latam Accelerator Report 2016"; LAVCA, "2017 Trend Watch: Latin American Venture Capital."

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