Journal of Business Research 62 (2009) 913–915

Contents lists available at ScienceDirect

Journal of Business Research

Teaching note Agora Partnerships Nicaragua

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ARTICLE INFO

Keywords:
Social venture capital
Entrepreneurial finance
New ventures financing
Emerging markets

ABSTRACT

This teaching note for the case Agora Partnerships Nicaragua summarizes two different approaches to teach the case. While the dilemma in the teaching case is how to structure an investment proposal attractive to both investors and entrepreneurs, the case also allows discussing how to adapt the venture capital model to an emerging country like Nicaragua. This teaching note outlines both logics, including a teaching plan for each one, assignment questions for students, and an overview of the discussion about the main issues in the two directions.

This teaching note accompanies the case Agora Partnerships Nicaragua: a Micro Venture Capital Fund. The case can be part or an Entrepreneurship course, or an Entrepreneurial Finance course, both in emerging markets. The case looks at the financing challenge that start ups face on these countries, as well as to a possible modification of the venture capital model that tries to overcome the shortcomings of the economic and social environment. The case assumes a basic knowledge on discounted cash flow techniques. The case also allows for a more qualitative discussion, and perhaps a more interesting one, for less technical audiences.

1. Teaching objectives

The case discussion can follow are two different paths. The first one is to focus on the design of the investment structure. Within this logic the case allows for:

1. qualitative comparison between equity structures
2. quantitative comparison between equity structures through sensitivity analysis with respect to the IRR of each investment
3. overall evaluation of appropriateness of using market solutions for ventures in developing countries
4. portfolio management — how to set performance targets and expectations for single investments in order to achieve a given return on the portfolio as a whole (considering, in turn, the debt and the equity piece).

However, a different approach is to use the case to discuss the similarities and differences on the Agora's model, relative to a more typical venture capital fund. Under this setting the teaching objective becomes:

1. Exploring how to adapt the venture capital cycle to emerging markets conditions.

The next sections consider both approaches, starting with the focus on the investment structure. An accompanying spreadsheet is available from the authors upon request. The model allows for a complete numerical analysis by the student.

2. First approach: design of the investment structure

This line of reasoning focuses on the structuring of the investment. The dilemma is how to put together something that works for the entrepreneur as well as for Agora. This approach makes intensive use of the accompanying spreadsheet, and the analysis is mostly numerical.

2.1. Assignment questions

The following questions are already in the case and address the above objectives:

1. Which buyback structure should Agora use to guarantee a fair deal to the entrepreneur but also a good return from each investment, given the extreme volatility in each portfolio company's performance?
2. What IRR should Agora commit to the donors/investors with regards to the equity portfolio? What returns on the debt and equity should Agora seek from each investment in order to achieve the target IRR on the debt and equity portfolios?
3. To which extent should Agora allow for third-party participation from commercial investors?

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doi:10.1016/j.jbusres.2008.10.011

Table 1
Teaching plan, focus on investment structure.

Subject	Time
1) Introduction and overall description of Agora Partnerships model	10 min
2) Quantitative analysis	40 min
A) Description of cash flows for analysis	10 min
B) Description and discussion of the structure options	15 min
C) Description and discussion of portfolio management	15 min
3) Description and discussion of third-party considerations	15 min
4) Closing	15 min
Session total	80 min

2.2. Discussion

The discussion can start with the most generic terms, comparing the pros and cons of debt and equity in the context of small enterprises in Nicaragua. The fact that the IADB provides limitations as to how to supply the funds, forces Agora to invest in the enterprises partly through debt. The issue, then, is whether to make the remaining part of the investment in the form of debt, equity, or something in between.

The main issue with respect to debt vehicles, whether straight or convertible, is that they risk suffocating the enterprise in their growth phase. More flexible terms can mitigate this risk but, given the high volatility in the cash flows projections for the business, risk remains an important issue. While debt offers protection from the downside, Agora might have to charge an extremely high interest rate to the ventures in order to allow the portfolio to achieve a minimum return. The advantage of debt is that interests are tax deductible and that a fix schedule for repayment of interests and principal would instill a certain financial discipline in the entrepreneur. The other, more significant advantage is that a debt-like instrument would not present the issue of exiting the investment.

On the other hand, an equity investment would allow the enterprise to grow with less immediate financial obligations and would also allow Agora a more direct, legitimate control over the enterprise. The key issue remaining is the exit strategy. Given the size of businesses Agora invests in (too small to be on the radar screen of merger and acquisition active companies) and the significantly underdevelopment of capital markets in the country, the option of a future IPO or an acquisition are not even available, leaving a buyback as the main feasible alternative.

Afterwards, the discussion can transition to a quantitative analysis of the different options. The spreadsheet file contains three types of worksheets with a total of five worksheets:

1. “Deal structure comparison” is the starting point, which allows the students to compare the 3 deal structures under consideration on the basis of a sample company with financials that they will have to make up themselves.
2. “Category financials” is a descriptive sheet containing the key financials for 6 different performance categories that is sample portfolio companies corresponding each to a “different performances”: “total failure–no repayments” to “major success–management buy-out or sale to strategic”.
3. Finally, “Option 1 portfolio performance,” “Option 2 portfolio performance,” and “Option 3 portfolio performance” show the behavior of the portfolios corresponding to each deal structure.

The model's structure follows the logical order for the analysis. The first spreadsheet allows the student to compare the IRRs according to each deal structure, keeping in mind that the model does not recognizes any value to eventual shares still owned in the company after 2015. The student can also look at the cash profiles, evaluating which option seems to be providing a more steady cash flow, and consequently, less sensitive to discrepancies between the expected and actual company performance.

Afterwards, the student should review the financials for each performance category, in the worksheet “Category financials,” looking specifically at the repayment terms for both the equity and the debt financing. Once the student selects a deal structure on the basis of the previous work, he can now evaluate the portfolio's performance depending on the hypothesis about the probability distribution of the venture performances.

The session can come to an end with a qualitative analysis of the advantages and disadvantages of allowing third party investors. Overall, the more capital Agora could access, the faster they could invest in Nicaraguan businesses, and, in turn, increase investor credibility. However, more investors increase the possibility of different expectations. This conflict becomes more important due to the need to balance a developmental mission with financial sustainability.

At the heart of the last dilemma lies the main innovation in the Agora model: the combination of a (micro) venture capital fund with and non-for-profit that decreases the due diligence and administrative costs of the fund. Third party investors will free ride on the subsidies the non-for-profit provides, while they probably seek only attractive returns on investment. Investors' expectations can, in turn, push Agora to deliver more aggressive returns, jeopardizing the social mission of the non-for-profit.

On the other side, these investors will provide with additional funds, allowing Agora to expand the number and perhaps the quality of the investments. The presence of third party investors could also booster credibility and opens the door to potential exit strategies (in the cases when the third party investor is a strategic one). Students typically tend to ignore the potential conflict of interest. While for Agora that conflict is very important due to the initial fundraising efforts are targeting foundations, development agencies, and other non-for profit entities.

2.3. Session plan

The following table provides a teaching plan for an 80 min session (Table 1).

3. Second approach: adapting the venture capital model to emerging countries

Instead of looking at the investment structure, this approach focuses rather on a more qualitative discussion of the venture capital model and how well the model can perform on a country like Nicaragua. The authors recommend to hand the students the full version of the spreadsheet with the professor analysis, so they can devote their preparation time to the study of the Agora model.

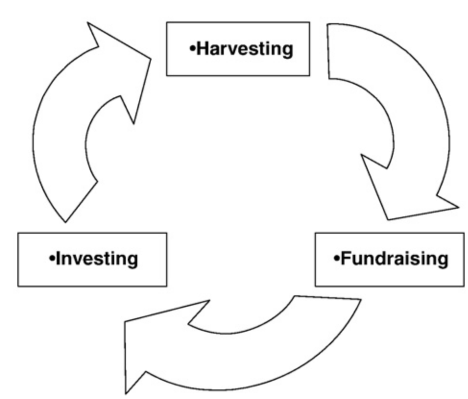

Fig. 1. The investor's cycle.