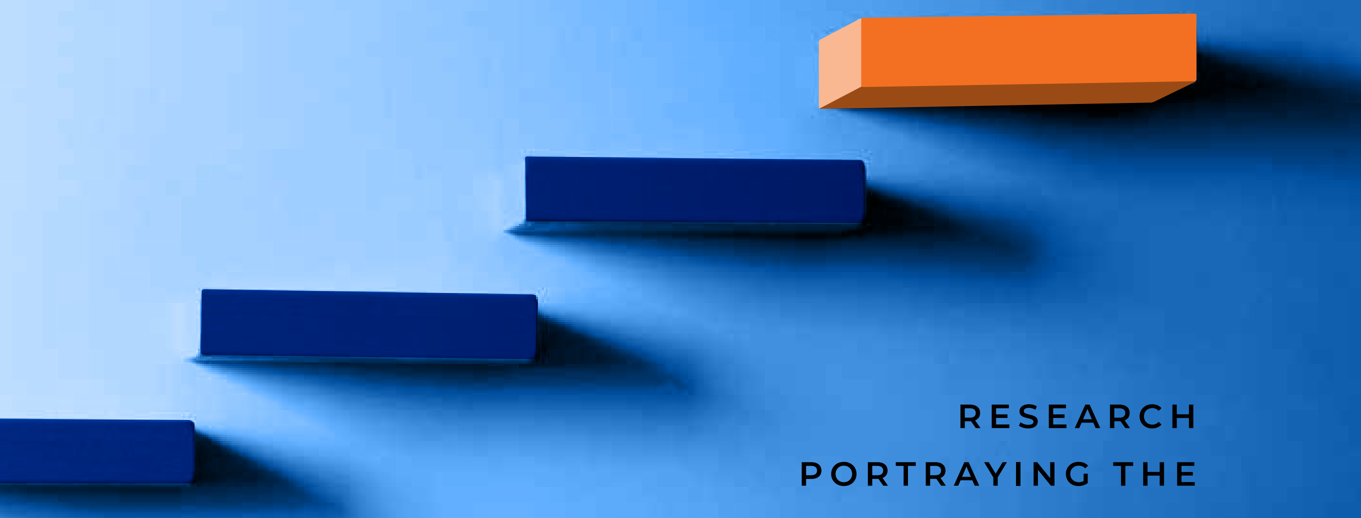
Startups & scale-ups: governance maturity



RESEARCH PORTRAYING THE OVERVIEW OF THE BRAZILIAN ECOSYSTEM

BETTER GOVERNANCE

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Startups & scale-ups: governance maturity

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BETTER GOVERNANCE

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Sandra Guerra, Founding Partner
Better Governance

We are a consultancy specialized in corporate governance (CG), which supports the improvement of the modelling and adoption of better CG practices in public, private and non-profit organizations. Our focus on boards of directors is the result of the belief in their relevance to governance models and of our wide experience with this collegiate body. Each project is tailor-made, envisions the intense involvement of senior consultants and adopts a pragmatic approach, resulting from our specialists' direct experience as managers and executives. By maintaining strong institutional links in Brazil and worldwide, Better Governance remains open to the latest academic findings and innovative market solutions in the implementation of the best CG practices.

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Summary

1. Introduction

CONTEXT

THE INVESTMENT scenario in the Brazilian ecosystem has continued to surprise year after year, having reached a record volume of US$ 10 billion in 2021, a growth of 194% during 2020 and a level 69 times higher than seen only a decade ago, when the sector's investment amounted for US$ 145 million.

2021 witnessed the most remarkable growth in the number of investment rounds (761), mergers and acquisitions (296 M&As) and IPOs (9). The average contribution per round was US$ 13.7 million in 2021, an increase of 150% over 2020 (US$ 5.5 million) and 760% over 2016 (US$ 1.8 million), according to the 2021 *Sling Hub Latin America Startup Landscape* report.

Since 2019, fintechs has been the sector with the highest volume of financing, and in 2021, this segment raised US$ 3.8 billion, almost 40% of the total investment in Brazil. Following this, retailtechs stand out with US$ 1.4 billion of financing, healthtechs

THE AVERAGE CONTRIBUTION PER ROUND WAS US$ 13.7 MILLION IN 2021, **AN INCREASE OF 150% OVER 2020 (US$ 5.5 MILLION) AND 760% OVER 2016 (US$ 1.8 MILLION).**

with US$ 501 million and edtechs with US$ 490 million.

The 2021 *Latin America Startup Landscape* report also outlines the boom of unicorns in the region. For more than a decade, Argentina was the only Latin American country with enterprises with a market value above US$ 1 billion: *Mercado Libre* (2007) and *Despegar* (2017). Brazil joined this list in 2018 and today it accounts for 60% of Latin American unicorns, followed by Argentina (17%) and México (11%). In 2021 alone, ten unicorns appeared in Brazil, totaling to date 19 startups with a valuation over US$ 1 billion.

Brazil has steadily and increasingly concentrated the largest part of the region's investments. In 2019, Brazilian startups received 45% of investments across Latin America, growing to 61% in 2020 and 70% in 2021.

Among the main startup investors in Latin America, the Chilean Start-Up, the biggest accelerator in the region, is considered the most active: 306 enterprises received funds from the company, followed by the Spanish Wayra, with investments in 213 startups. In third place is the Brazilian Bossa Nova with 179 investments.

RESEARCH MOTIVATORS

The steady growth of investment in Latin American startups, with a focus on Brazil, sends a clear message that the Brazilian ecosystem is maturing and consolidating, having, as a priority, the Latin America itself as a focus market for expansion.

This scenario highlights the need of a more conscious, dynamic, and sophisticated look at governance in the Brazilian entrepreneurship ecosystem. Governance can and should be seen as a gradual journey in terms of awareness and implementation, which needs to respect the many stages of business development, enabling a healthy evolution and the creation of value for high-growth companies.

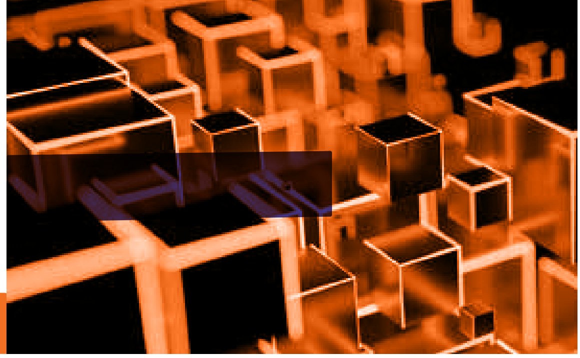
A governance structure, properly customized and implemented according to the development stage of a business, acts in the aid of the startup, allowing it to: strengthen its management model, enhance its valuation, facilitate access to an increasingly demanding and qualified funding, and improve its survival rate.

In this context, Better Governance has devised a specific governance model for startups[1] and scale-ups[2], used as a basis to conduct a survey aimed at understanding the level of governance maturity and its suitability for the development phases of startups and scale-ups in Brazil. The data-collection phase of this project was carried out between October 2021 and February 2022, and the questionnaire was disseminated through a partnership with the *Associação Brasileira de Startups*, *Distrito*, *BNDES Garagem*, *Cubo*, *Instituto Brasileiro de Governança Corporativa* (IBGC) and *InvestSP*.

With the results of this study, Better Governance presents a new overview of the governance maturity of startups and scale-ups, generating important reflections on how to strengthen the entrepreneurship ecosystem in Brazil.

GOVERNANCE CAN AND SHOULD BE SEEN AS A **GRADUAL JOURNEY** IN TERMS OF AWARENESS AND IMPLEMENTATION.

[1] Innovative scalable organization with high economical potential (not necessarily linked to technology).
[2] An enterprise whose accelerated growth cycle and creation of wealth is based, mainly, in the scalability of its business model (*Endeavor* definition).



2. The Governance Maturity model

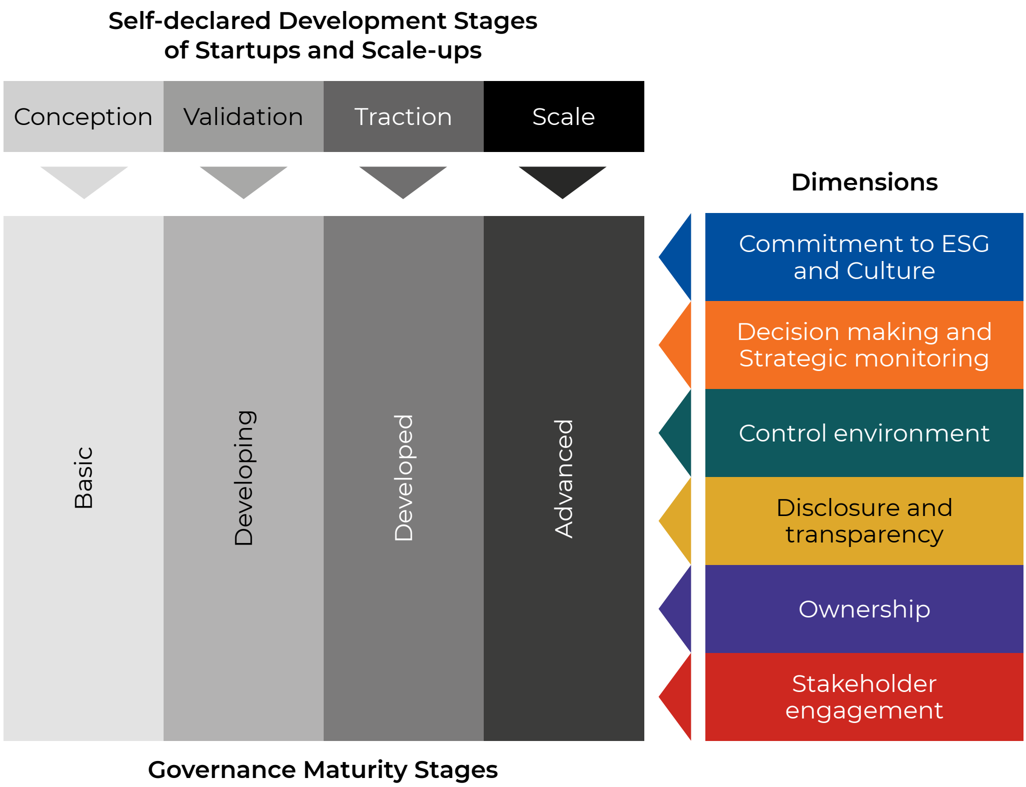
IN ACCORDANCE with the methodology developed by Better Governance, the Governance Maturity model was created from the concepts proposed by the IFC's (*International Finance Corporation*) governance progression matrix for small and medium-sized enterprises, which establishes practices within six dimensions, classified into four maturity stages – from basic to advanced. These governance maturity stages are then compared with the four stages of startup and scale-up development, as established by the "Corporate Governance for Startups and Scale-ups" guide, published by the IBGC (*Instituto Brasileiro de Governança Corporativa*) in 2019.

The result of the model is represented by the Governance Maturity Matrix for Startups and Scale-ups, which studies the alignment between the maturity stage in each governance

THE RESULT OF THE MODEL IS REPRESENTED BY THE **GOVERNANCE MATURITY MATRIX FOR STARTUPS AND SCALE-UPS.**

dimension and the development stage of the business, as declared by the entrepreneurs themselves. In addition, greater granularity is provided for the analysis of governance practices in each dimension in relation to the IFC SME Matrix, to allow for a clear view of the progression levels in their governance maturity journey.

GOVERNANCE MATURITY MATRIX FOR STARTUPS AND SCALE-UPS



Source: *Better Governance*

2.1. Six Governance Dimensions

With the aim of identifying the governance maturity of a company, Better Governance adapted the practices, processes and mechanisms provided for in the six dimensions defined in the IFC SME Matrix.

1. **Commitment to ESG and culture:** this dimension encompasses governance guidelines, models, and processes, in addition to the company's alignment with ESG principles (environmental, social and governance).

2. **Decision making and strategic monitoring:** observes the company's decision-making models with investors, advisors, consultants, or mentors' participation, in addition to its main executives. This dimension includes the formalization of the board of directors and its committees, as well as these bodies' evaluation.

3. **Control environment:** considers the level of financial, accounting, and strategic control structure, in addition to the company's management system and risk monitoring.

4. **Disclosure and transparency:** assesses the level of preparation and transparency of the company's financial and strategic information, supported by an audit process for its approval by relevant bodies.

5. **Ownership:** addresses agreements between partners, the level of formalization of partners and/or future partners' responsibilities (rights and duties), in compliance with a shareholder's agreement and bylaws, among other documents, and defining accountability mechanisms for shareholders such as extraordinary general meetings.

6. **Stakeholder engagement:** deals with the company's level of structuring and knowledge regarding its stakeholders, as well as its capability to identify and address questions and criticism involving related parties.

2.2. Four Stages of Governance Maturity

The analysis of the practices described in the six governance dimensions results in four maturity stages as defined in the IFC SME Matrix:

Basic: at this stage, the company presents informal governance practices, or the minimum formalization needed to operate at all levels. Concepts and values are intrinsic to partners and shared tacitly.

Developing: initial level of formalization, in response to legislation, market requirement and/or preparation for growth.

Developed: optimal level of formalization regarding structure and governance, addressing the company's own organizational complexity due to outstanding market performance.

Advanced: state-of-the-art governance, constantly evolving, which is fostered by a strong culture and safeguards all ESG principles.

2.3. Four Stages of Startups and Scale-Ups Development

In addition, the model developed by Better Governance considers the four stages in the evolutionary path of a startup, as presented by the IBGC:

1. **Conception:** the startup lies between the materialization of an idea and the understanding of a problem to be solved or the market share it seeks to occupy.

2. **Validation:** the startup's product, market, and business model are still in the experimentation phase, with the aim of resolving uncertainties raised during the Conception Stage.

3. **Traction:** the product or service provided by the startup is validated; main

obstacles are summarized as gaining customers and increasing revenues without abandoning the values and principles of the organization.

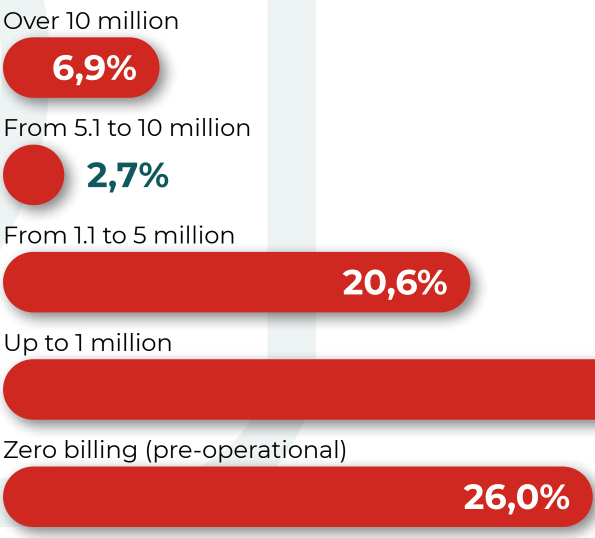
4. **Scale:** the company has been already set up and its challenge is to expand at a fast pace, seize opportunities and grow, from a geographical, market or product perspective, in addition to the possibility of replication if the business model allows.

3. A Snapshot of Startups and Scale-ups

THE SURVEY obtained 146 valid responses from Brazilian startups and scale-ups, distributed across 20 states. Most of the companies that make up this research sample (close to 74%) are very young, with less than five-years since their foundation. This issue can be aligned with other characteristics of the sample, such as:

26% OF THE COMPANIES ARE IN THE ZERO-REVENUE BILLING PHASE (PRE-OPERATIONAL) AND AROUND **44%** BILL UP TO R$ 1 MILLION PER YEAR.

AVERAGE LAST FISCAL YEAR BILLING AMOUNT



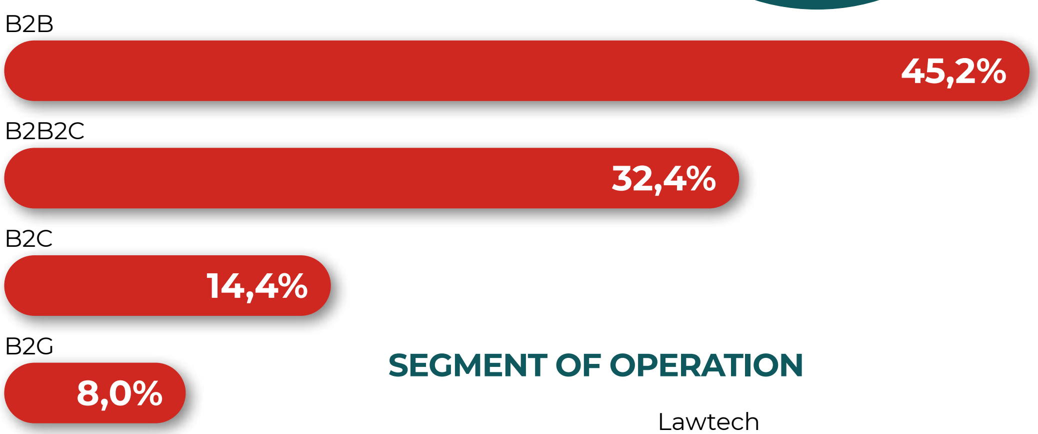
Sample: **146** respondents

68% OF THE COMPANIES HAD NOT GONE THROUGH INVESTMENT ROUNDS WHEN THE SURVEY WAS CONDUCTED.

39% RECEIVED A CONTRIBUTION OF UP TO R$ 500,000.

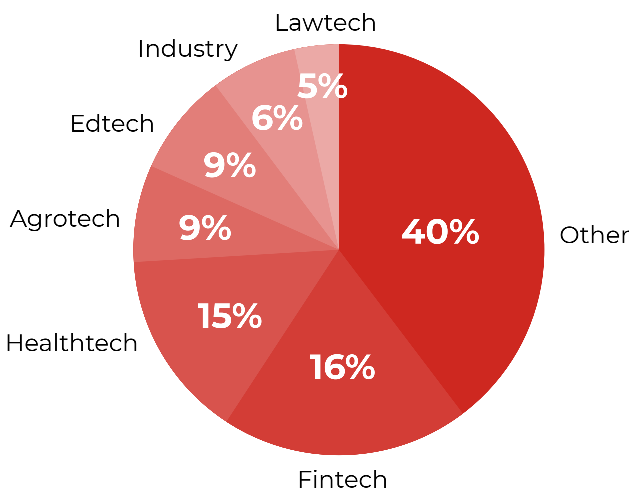
45% FALL IN THE B2B BUSINESS MODEL, FROM WHICH **16%** CORRESPOND TO THE FINTECH SEGMENTS, AND **15%** TO HEALTHTECH.

BUSINESS MODEL



Sample:
146 respondents

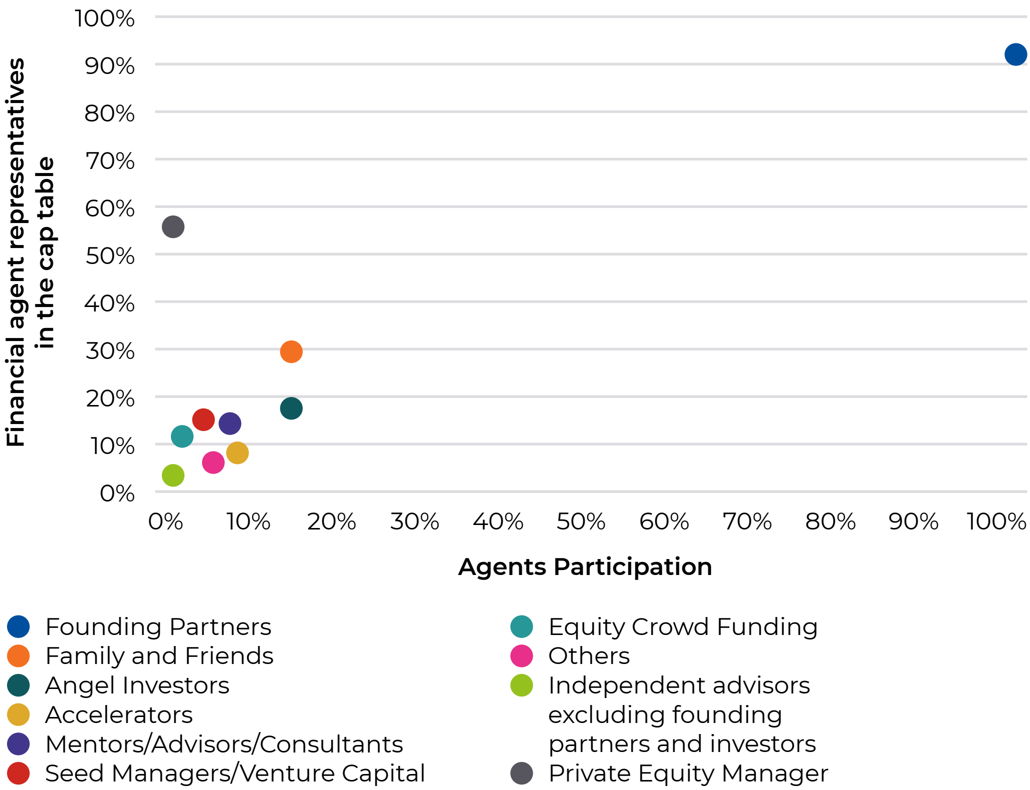
SEGMENT OF OPERATION



Sample:
146 respondents

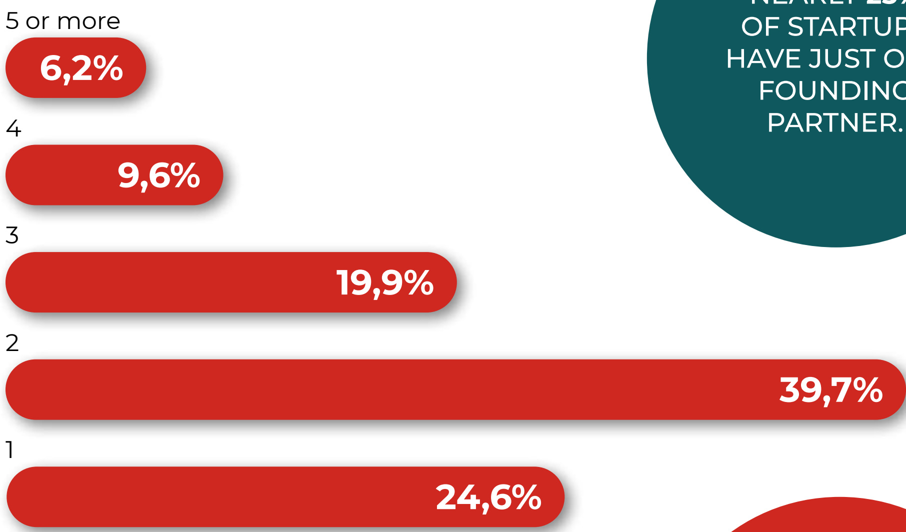
THE CORPORATE STRUCTURE OF THE RESPONDENT COMPANIES REVEALS THAT ALL OF THEM HAVE FOUNDING PARTNERS IN THEIR OWNERSHIP (CAPITALIZATION TABLE), RESPONDING TO ON AVERAGE **92%** OF THE EQUITY INTEREST IN THESE COMPANIES. PRIVATE EQUITY FUNDS ARE PRESENT IN ONLY **2%** OF THE RESPONDENTS' OWNERSHIP STRUCTURE, WITH AN AVERAGE OF **56%** OF OWNERSHIP PARTICIPATION.

PARTICIPATION OF ECOSYSTEM AGENTS IN THE CORPORATE STRUCTURE



Sample:
111 respondents

NUMBER OF FOUNDING PARTNERS



Sample:
146 respondents

NEARLY **25%** OF STARTUPS HAVE JUST ONE FOUNDING PARTNER.

60% OF COMPANIES ARE BASED IN THE SOUTHEAST REGION, FROM WHICH **45%** ARE IN THE STATE OF SÃO PAULO.

42% OF FOUNDING PARTNERS ARE BETWEEN 36 AND 45 YEARS OLD.

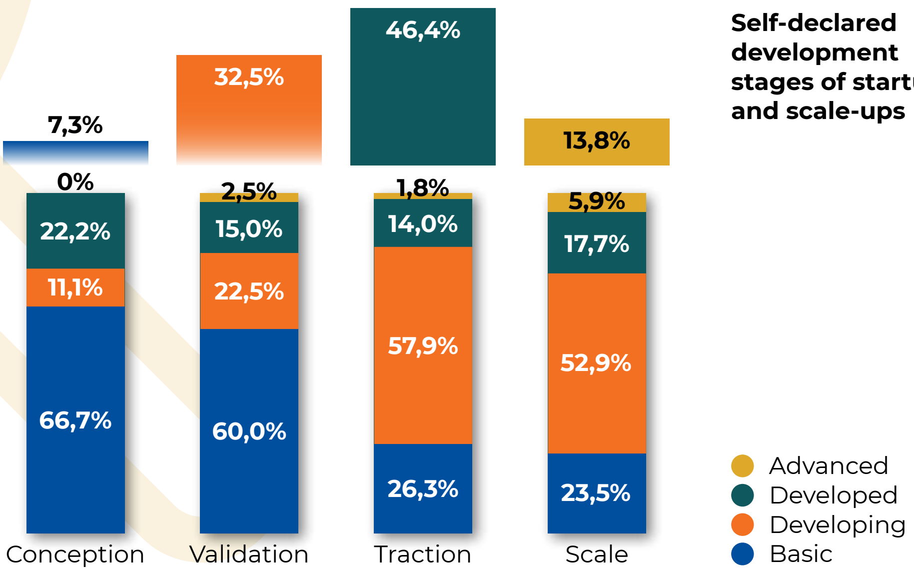
15% OF INVESTING PARTNERS BELONG TO ANGEL NETWORKS AND **15%** BELONG TO FAMILY AND FRIENDS.

67% OF RESPONDENTS HAVE FROM ONE TO TEN EMPLOYEES EMPLOYEES.

66% OF COMPANIES ARE LIMITED COMPANIES, **12%** ARE CORPORATIONS AND **13%** ARE NOT YET FORMALIZED.

4. Results

WHEN SIMULTANEOUSLY identifying the business development phase of the startups and scale-ups, self-declared by participants, and their corresponding stage of governance maturity, the survey allowed for the assessment of the evolution speed of these two variables. As a result, it was found that of the 60.1% of companies that declare themselves to be in the most advanced development stages (Traction or Scale), 82.4% are in the in the early stages of governance maturity (Basic or Developing). This demonstrates one of the main findings of the research: the existence of a mismatch between the two variables assessed.



Self-declared development stages of startups and scale-ups

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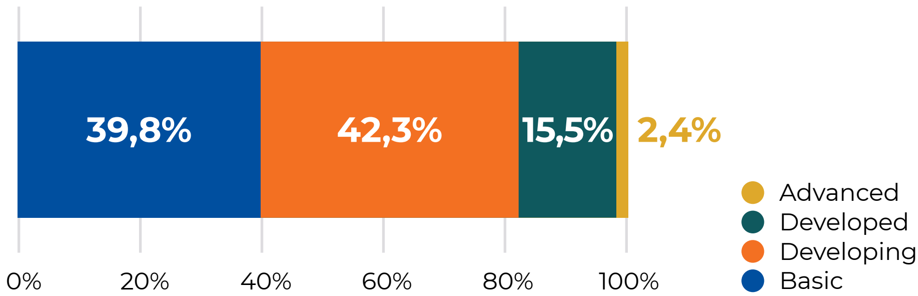
Considering only the governance maturity stage, regardless of the self-declared development stage, it was observed that nearly 40% of the responding companies are in the Basic Stage and about 42% in the Developing Stage.

Almost 15% of the sample is in the Developed Stage of governance maturity and only 2.4% of respondents can be considered to be in the Advanced Stage.

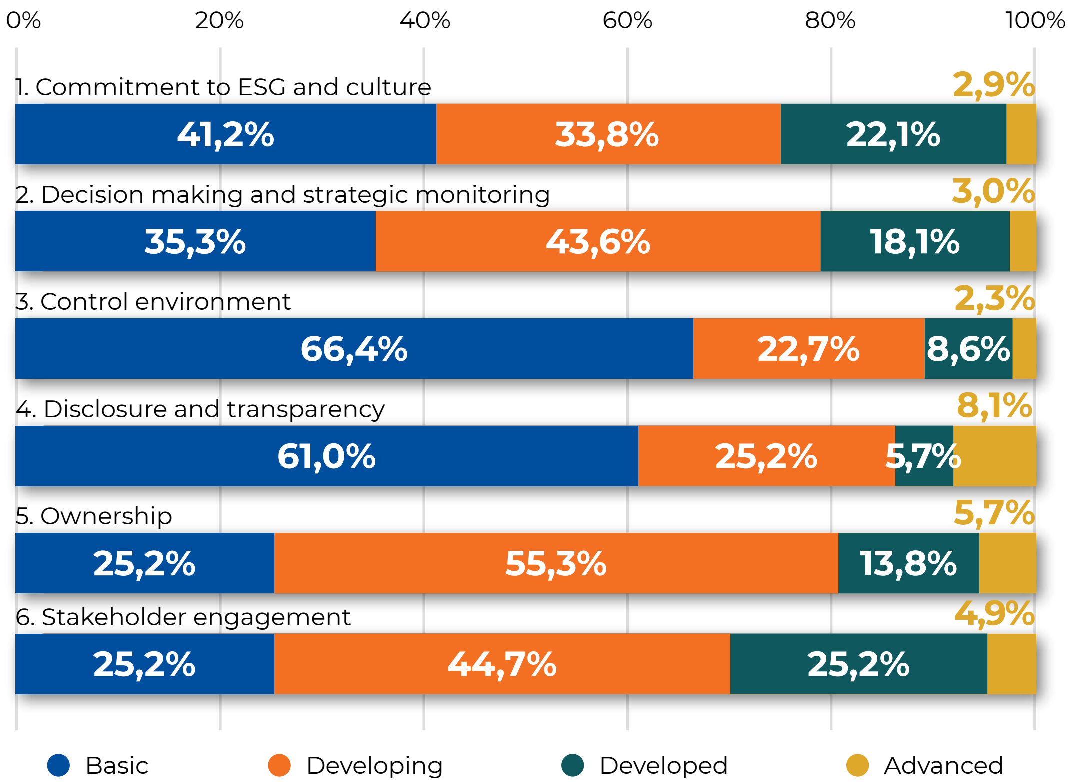
GOVERNANCE MATURITY STAGES



The mismatch between the development stage of the business and the maturity stage of the management structure highlights the lack of awareness among startups and their financing agents regarding in-depth and better understanding of the relevance that the implementation of better governance practices has for the prosperity and perpetuity of the business. It also points to the opportunity for devising action plans that dynamically implement governance practices according to the business' different evolutionary stages, which overall would prepare and support the steady growth of Brazilian startups and scale-ups.

Additionally, it is also possible to analyze each dimension of the governance maturity stages through the sample obtained.

STAGES OF GOVERNANCE MATURITY BY DIMENSION



Through the analysis of the values mentioned above, it is observed that the **Control environment** and **Disclosure and transparency** dimensions were the least evolved, revealing management practices and tools yet to be developed in the startups and scale-ups surveyed.

In **Control environment**, for instance, this may imply that there are few applications of audit processes, with control being focused only on preparation of internal accounts for the founders. It is also possible that risk management is still in the basic stages, without policies or monitoring procedures. In the **Disclosure and transparency** dimension, even though the preparation of accounts considers basic features, it does not meet the country's requirements. Thus while information that is shared internally within the organizations may be consistent, it is created without assurance from external audit processes.

The **Ownership** and **Stakeholder engagement** dimensions present results that are more in line with the Developing Stage. Specifically, in **Ownership** companies present a clear distinction in the roles of the founding partners, investors-partners and other shareholders, investors, and executives. Moreover, they appear to be more focused on preparing their ownership structure for possible additions of new partners or protecting the capital invested by the founding partner.

Regarding the **Commitment to ESG and culture** dimension, practices are still in the Basic Stage, considering only principles such as purpose alignment, vision, mission and values, and formalization of codes of ethics.

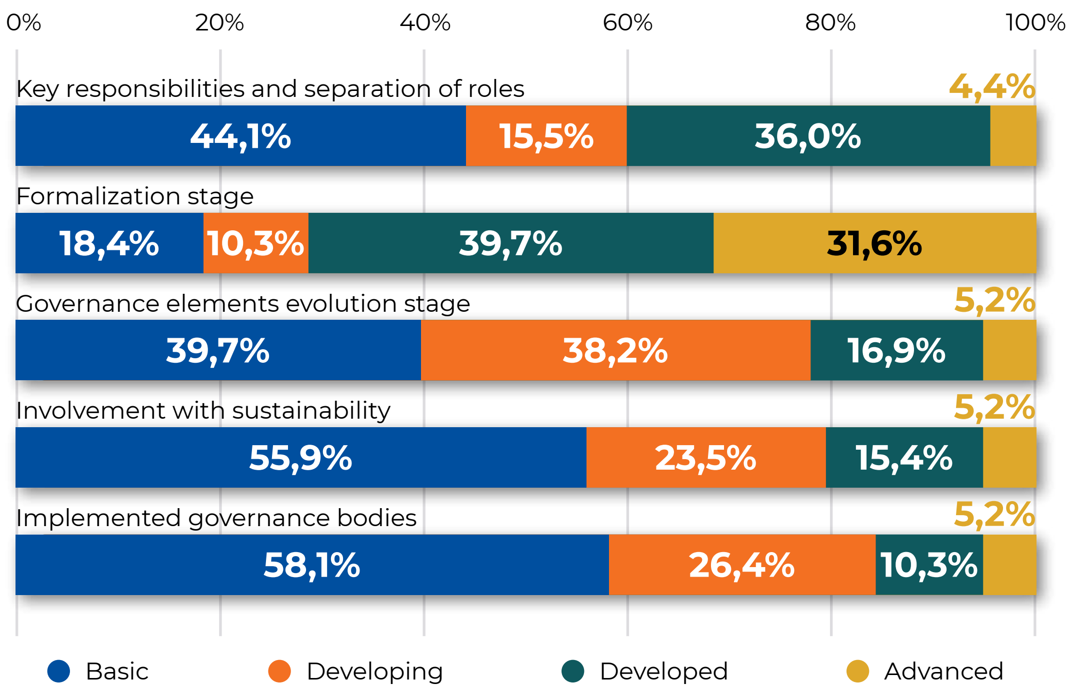
The decision-making processes and strategic monitoring are still guided by the **partners' vision**, with occasional discussions and sharing with mentors. The remuneration policy is more aligned with the Developed Stage, with more than 56% of startups having fixed, variable salaries and bonuses.

4.1. Results by Governance Practices

To increase the analysis granularity, this research presents a vision of the maturity of startups and scale-ups per governance practice that make up each one of the six dimensions:

4.1.1. Commitment to ESG and culture

DIMENSION 1: COMMITMENT TO ESG AND CULTURE

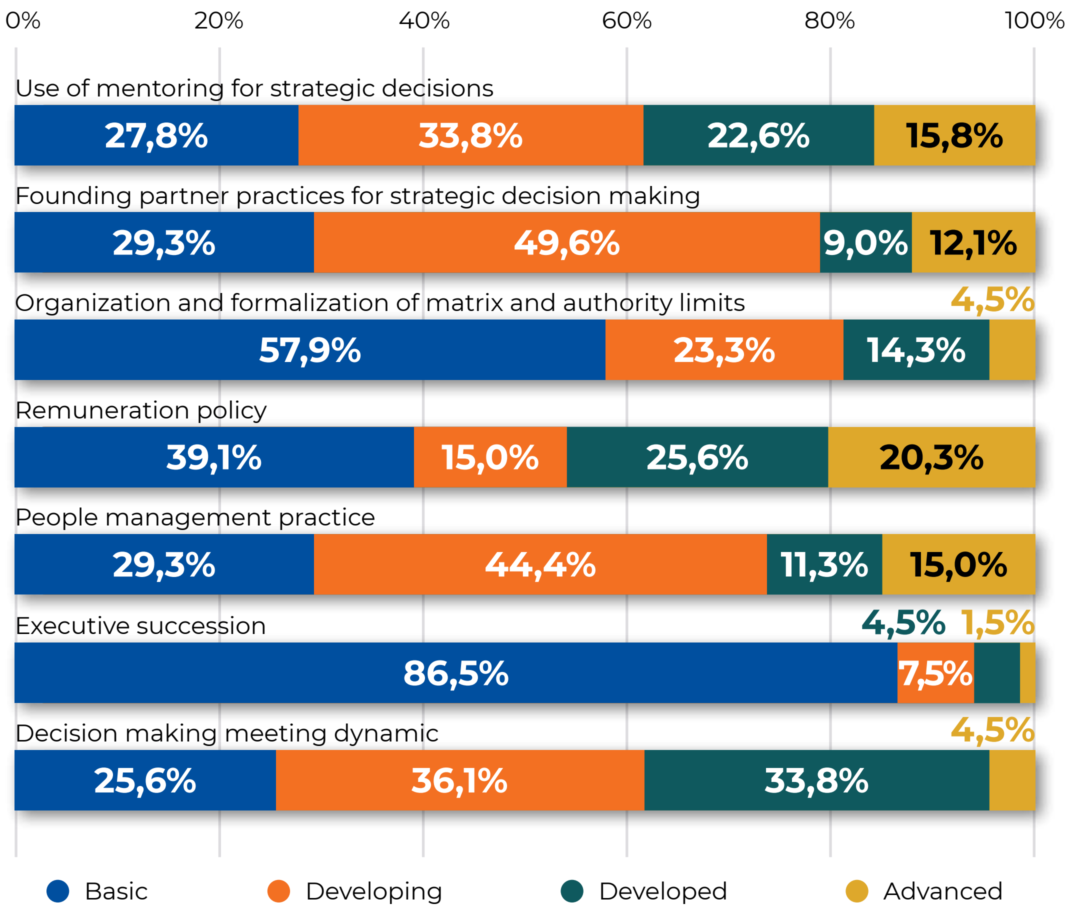


- Commitment to ESG and culture practices are still in early stages of maturity, except for issues related to formalization, such as corporate acts, statutes, and social contracts. Despite this, governance remains in the Basic Stage, supported by the trust and experience of the founding partners and focused on management practices.

- Even though most respondents have reached satisfactory levels in terms of formalization, the alignment to ESG principles practices and implementation of governance practices do not reveal good results and suggest an opportunity for improvement.

4.1.2. Decision making and strategic monitoring

DIMENSION 2: DECISION MAKING AND STRATEGIC MONITORING



- Decision-making and strategic monitoring practices are still in the early stages of maturity, except for those related to the use of mentoring practices and remuneration policies.

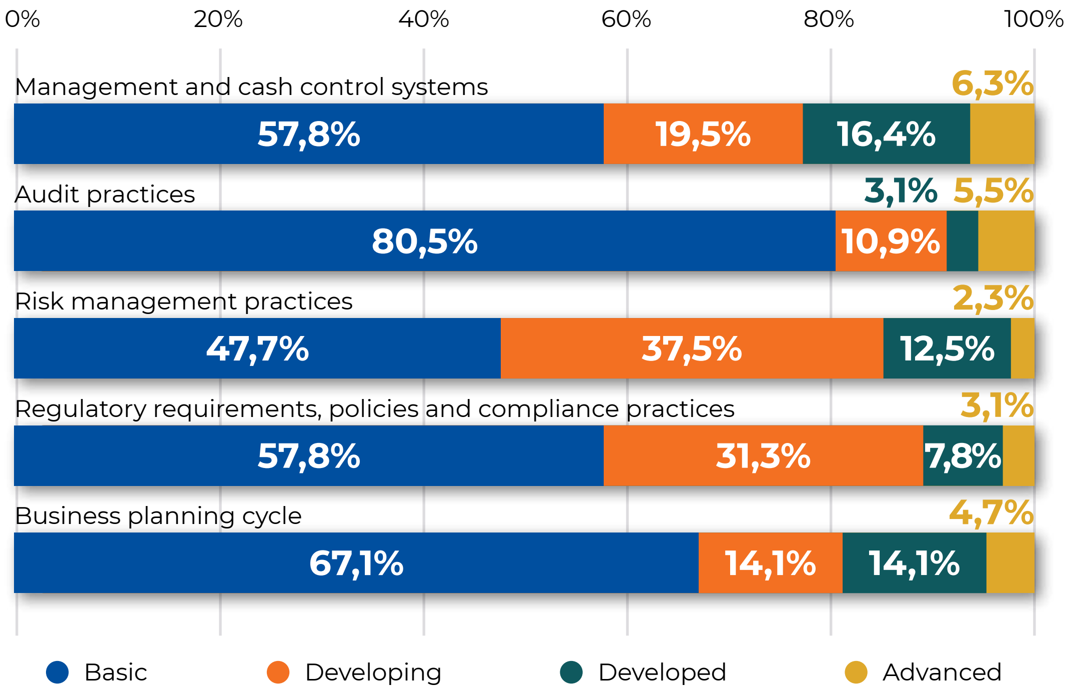
- Strategic decisions continue to be guided by the partners' vision, with occasional discussions and sharing with mentors. Decisions are focused on the group's executives and based on informal levels of authority.

- The remuneration policy is in line with the Developed Stage, with more than 56% of the companies having fixed, variable remuneration plus bonuses. However, this is not accompanied by a set of people management practices, which are limited to sporadic practices.

- Companies have not yet structured processes of organization and formalization of their matrix, authority limits and succession processes, which can result in obstacles to the growth stages and should be addressed in the early stages of the business.

4.1.3. Control environment (internal control system: audit, risk, compliance)

DIMENSION 3: CONTROL ENVIRONMENT

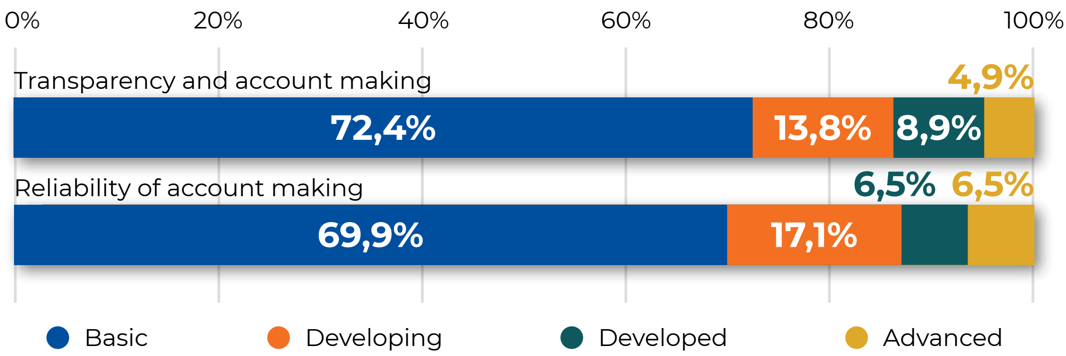


- Control environment presents more fragility in terms of audit practices and the planning cycle of the company.

- Issues related to strategic planning, control systems, audit and risks came up as the main opportunities of improvement.

4.1.4. Disclosure & transparency

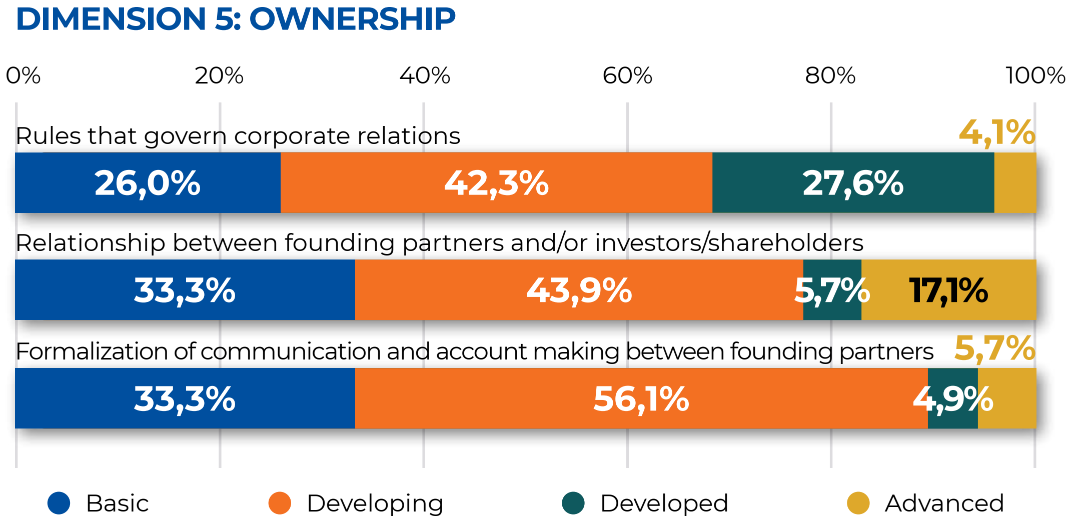
DIMENSION 4: DISCLOSURE AND TRANSPARENCY



- Disclosure and transparency is also in very early stages, with few applications of audit processes. When audits are carried out, they are concentrated and focused on the preparation of accounts for the founders.

- Reliability in the preparation of accounts, which is still in the Basic Stage, may bring about problems in future development stages, generating an alert for this practice.

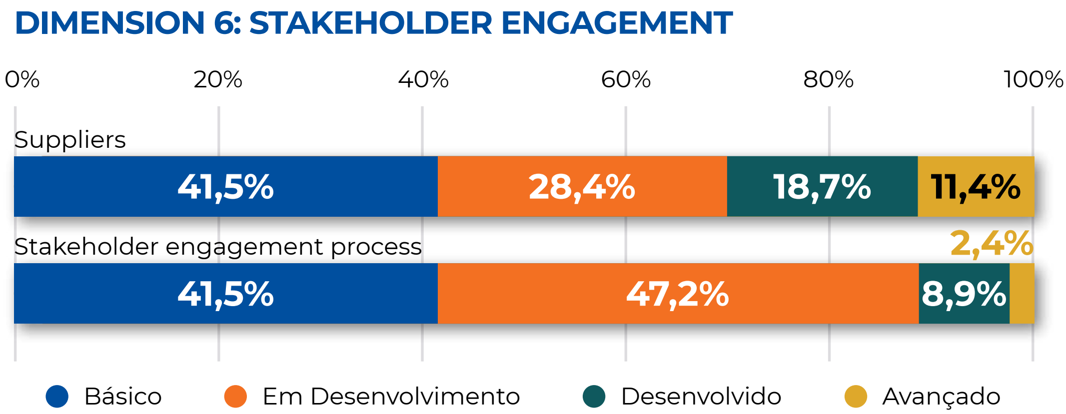
4.1.5. Ownership



- Respondent companies in this dimension were showed to be focused on preparing the company for future inclusion of new partners or even safeguarding the capital used by the founding partner.

- Even though the Disclosure and transparency dimension pointed out at low reliability in the preparation of accounts, Ownership indicates a more positive direction towards the formalization of this process.

4.1.6. Stakeholder engagement



- The Stakeholder engagement dimension is still very focused on the relationship with suppliers, with little emphasis on the strategic ones. Relationships with stakeholders are still reactive in most companies.

5. Methodology

THIS SURVEY was carried between November 2021 and February 2022. It was conducted through an online questionnaire based on the Governance Maturity Model for Startups and Scale-ups developed by Better Governance. To obtain the responses from startups and scale-ups, the survey link was sent to the databases of the following six partners: *ABStartups*, *BNDES Garagem*, *Cubo*, *Distrito*, *IBGC*, *InvestSP*, in addition to Better Governance itself. The professionals who responded on behalf the companies had the following roles: Manager/Executive/ Employee, Founding Partner, Investor Partner, or Operating Partner.

The sample contains data from 146 companies. Inconsistent and incongruous responses were removed. Respondents were authorized to not answer questions whose answers they did not know. Missing data did not cause the elimination of the rest of the answers when the treatment of the other data was not affected. In some analysis, all responses that

THE PROFESSIONALS WHO RESPONDED ON BEHALF THE COMPANIES HAD THE FOLLOWING ROLES: **MANAGER/EXECUTIVE/ EMPLOYEE, FOUNDING PARTNER, INVESTOR PARTNER, OR OPERATING PARTNER.**

contained enough data were used, and those that missed some elements to cross-reference the data were excluded. In that way, all consistent data was used.

To analyze the information, an approximation of numerical values to avoid the display of decimal places was used, without affecting the conclusions drawn from the data. References for the creation of this survey are supported by literature on corporate governance as well as by IBGC (2019) and IFC (2021) studies on governance maturity in startups and scale-ups.

Better Governance is an innovator in the initiative of combining different methodologies on governance maturity and evolution stages of startups and scale-ups, widening the granularity of this type of analysis when establishing practices that make up each governance dimension. Therefore, it is possible to deepen the analysis of startups and scale-ups' governance maturity, aiming to identify strengths and opportunities of improvement for these companies present in the Brazilian ecosystem, highlighting the relevance of corporate governance for better results.

A possible limitation of this study is relatively small sample when compared to the total number of Brazilian startups and scale-ups. Thus, our analysis and conclusions must not necessarily be extrapolated to the wider business universe.

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