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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

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what lies ahead – a new investment model

paper presented by:

beatrice e rangel
senior advisor to the chairman, cisneros group of companies

What Lies Ahead: A New Investment Model

By Beatrice E. Rangel

"The Internet in Latin America: Investigating the Boom"

Latin American Newsletters Conferences

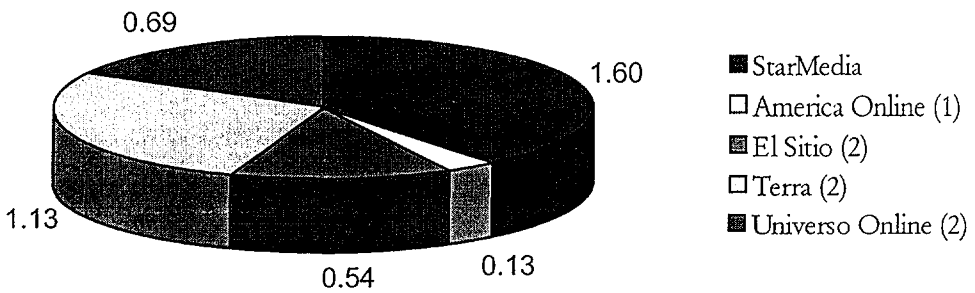
London, October the 11^{th} and 12^{th}, 2000

I. INTRODUCTION

Over the past three years, Latin America has been the land of the Internet Big Bang. In that short time span, 9 million people—or 2 % of the population—got connected. Internet usage in Latin America grew faster than anywhere else in the world—with an eightfold increase between 1995 and 1997. By the year 2003, the number of users should rise to 38 million representing about 8 percent of the market. Also according to a 1997 study by the advertising agency Saatchi and Saatchi, Spanish ranks as the second most frequently used language on the Internet. With enhanced production of content and as investments in the telecommunications increase telephony coverage, the region has been seen by investors as the most promising destination for financial resources. Business use of the Internet has also experienced an impressive growth. IDC estimates that 90% of businesses in the region had or were developing a Web site by the end of 1998. Also 80% had or were developing an Intranet, while 45% of companies had or were developing and Extranet. With respect to e-commerce, IDC reports that 44% of Latin American countries had or were developing e-commerce-enabled sites.

These developments prompted a wave of investments in Internet-related ventures in Latin America that climbed from US$500 million in 1997 to US$3 billion in 1999. Pan regional portals flourished that year with AOLA, El Sitio, StarMedia, Terra, and UOL establishing themselves as the unquestionable market leaders.

Table I
Leading Internet Portals in Latin America
(per million subscribers)

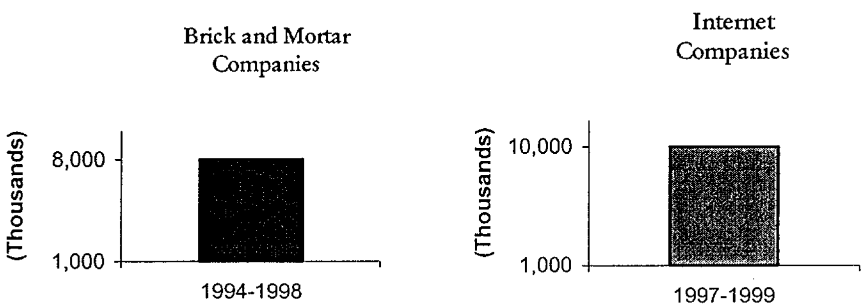


(1) Brazil Subscribers Only
(2) Pan-Regional Subscribers Only
Source: IDC

A myriad of less visible, vertical, and country-specific portals have also emerged. The Economic Commission for Latin America and the Caribbean has estimated that approximately 10,000 internet-related ventures were established in Latin America from 1998 to 2000. To realize the significance of such data, it would suffice to compare it with the rate of creation of new companies by the brick and mortar economy that accounted for 8,000 in five years.

Table II

New Enterprises in Latin America



Source: ECLAC

At the heart of this impressive development were the economic reform policies adopted by the Latin American countries during the late 1980s and throughout the last decade of the twentieth century. These policies restored macro-economic equilibrium and created better links to the world economy thereby developing an investment-friendly economic environment. Foreign direct investment began to flow back into the region at rates that had not been experienced since the decade of the 1970s. Investment flows were particularly strong in the service economy, as the countries in the region proceeded to privatize utilities, including media and telecommunications concerns. Foreign direct investment in the service economy skyrocketed reaching US$81.2 billion in the last three years of the past decade with mergers and acquisitions taking the lead during that period.

TABLE III

Mergers and Acquisitions in Selected Latin American Countries

(In US$ millions)

Country	1997	1998
Argentina	$ 2.612	$ 1.544
Bolivia	0.104	0.180
Brazil	10.381	21.282
Chile	1.263	1.011
Colombia	1.411	1.084
Ecuador	0.280	0.047
El Salvador	0.420	0.426
Guatemala	0.000	0.582
Mexico	5.821	0.392
Panama	0.003	0.520
Peru	0.544	0.158
Uruguay	0.001	0.029
Venezuela	1.197	0.345
Total Selected Countries	**23.407**	**27.600**
Total Latin America and the Caribbean	**25.579**	**31.208**

Source: Unctad

Foreign investment flows paved the road to the successful entry of the Internet in the region by planting the pillars of telephony connectivity.

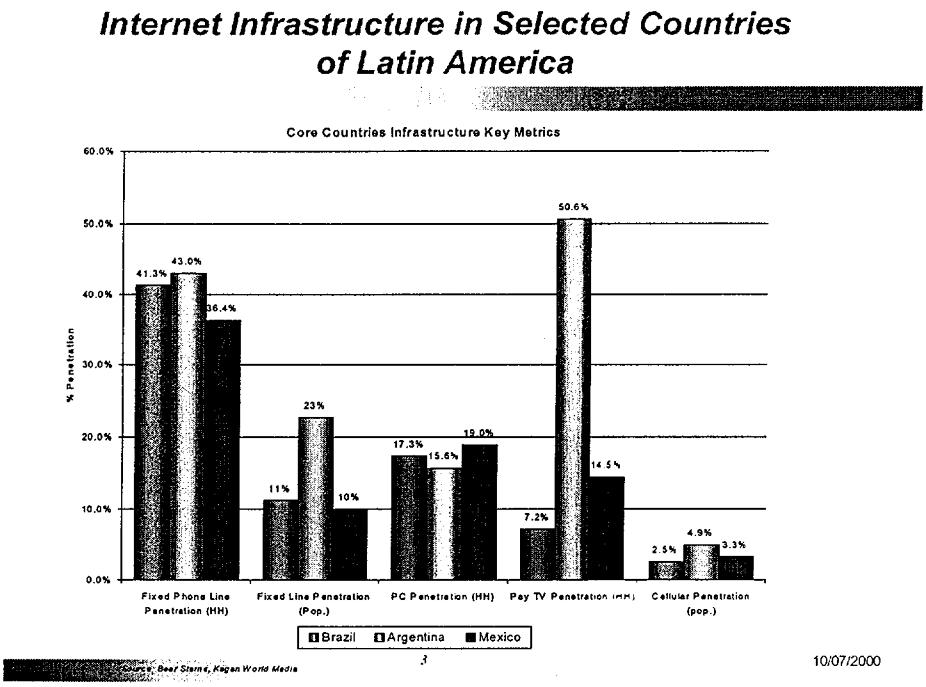
On the other hand, enhanced trade through tariff reduction and the elimination of export subsidies created a new consumer culture in the region. For the very first time in history, Latin American consumers began to experience freedom of choice. Consumers thus flocked to the Internet as the conduit for e-commerce, yet another means to enhance their range of choice for products and service acquisition. Further changes in consumer behavior were induced by taming the inflationary shrewd. Over the past decade, Latin America was able to enhance purchasing power by reducing inflation from an average of 100% to the current 16%. This is equivalent to an overall transfer of purchasing power of 35% to consumers. For every dollar increase in purchasing power, Latin American consumers spent 85 cents in durable products including personal computers.

In short, the economic reform policies of the late 80s and 90s and the ensuing demand for Internet services and e-commerce of approximately 100 million individuals that comprise the affluent clusters of Latin American societies have so far sustained the current boom. This boom has also benefited from the most enduring bull market in the United States financial community. This generated a surplus of investment resources without parallel in history.

The question that now arises is whether the Internet boom is sustainable. To effectively respond this question one must identify the factors that will nurture the future sources of Internet growth.

II. THE SOURCES OF PAST GROWTH:

Foreign Direct Investment in Latin Telecommunications was one of the most tangible product of economic reform. To be sure, investments in telecommunications ventures changed the economic landscape for the region by promoting growth in the communications and electronic media industry and creating the platform for Internet growth.

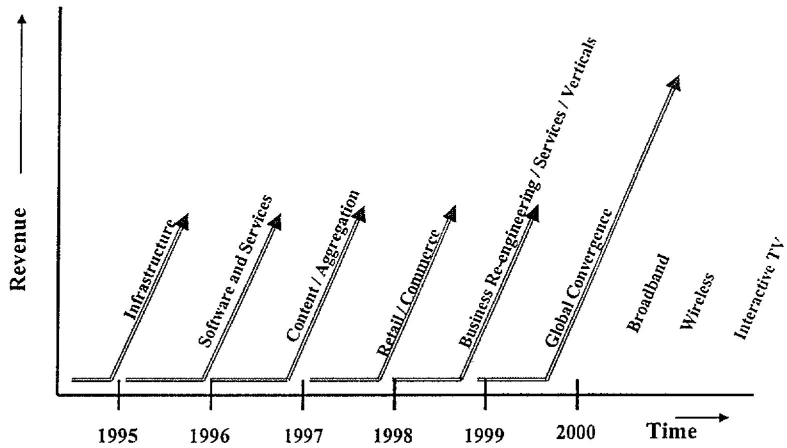


The following effects of privatization drove this impressive development in the Internet infrastructure on the telecommunications industry:

- Market growth through competition
- Better service through advanced technologies
- Introduction of value-added services

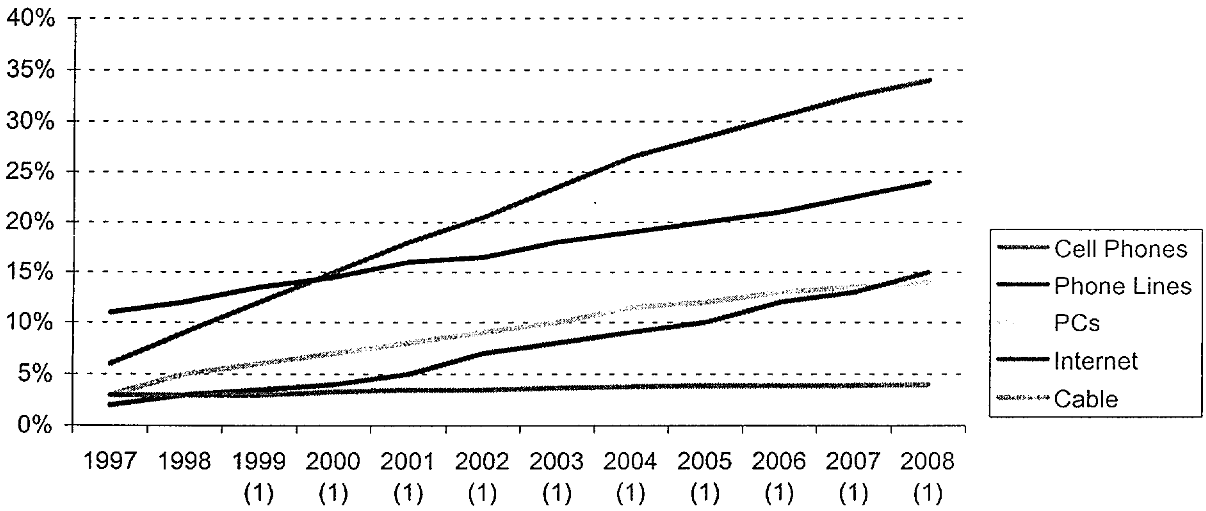
From the consumer spending viewpoint, the marginal propensity to acquire durable products including entertaining equipment and personal computers account for the growth in Pay television penetration and Internet connectivity. Anti-inflationary policies fueled the consumption boom for these goods.

Path of Growth



Source: Holdinvest

Penetration Rates in Latin America

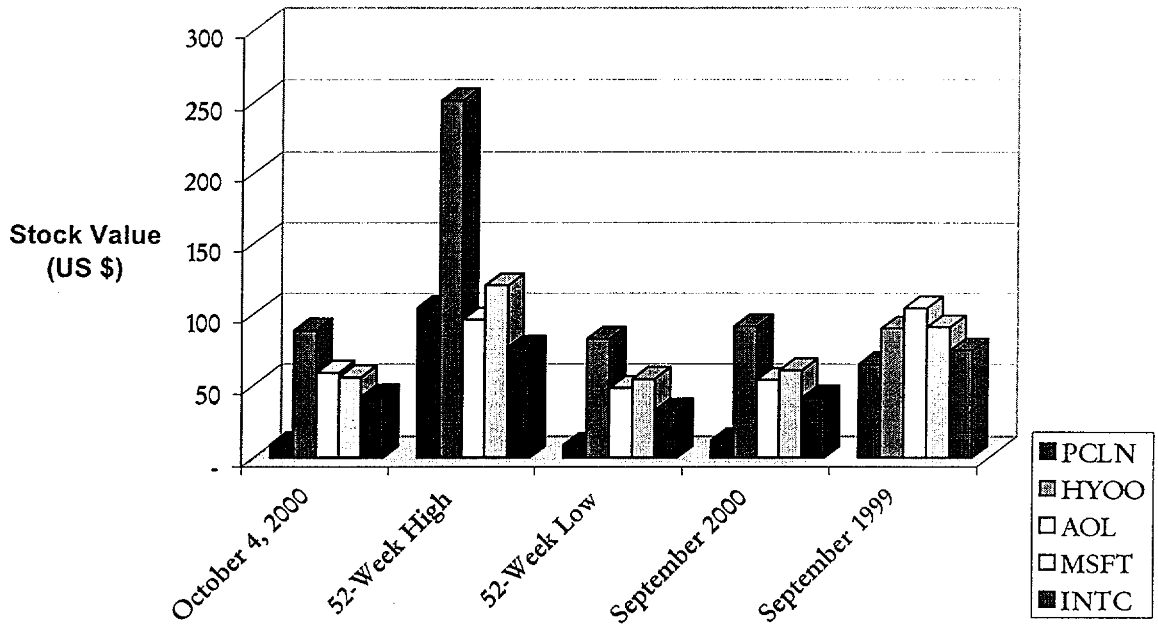


(1) 1999 to 2008 are Estimates

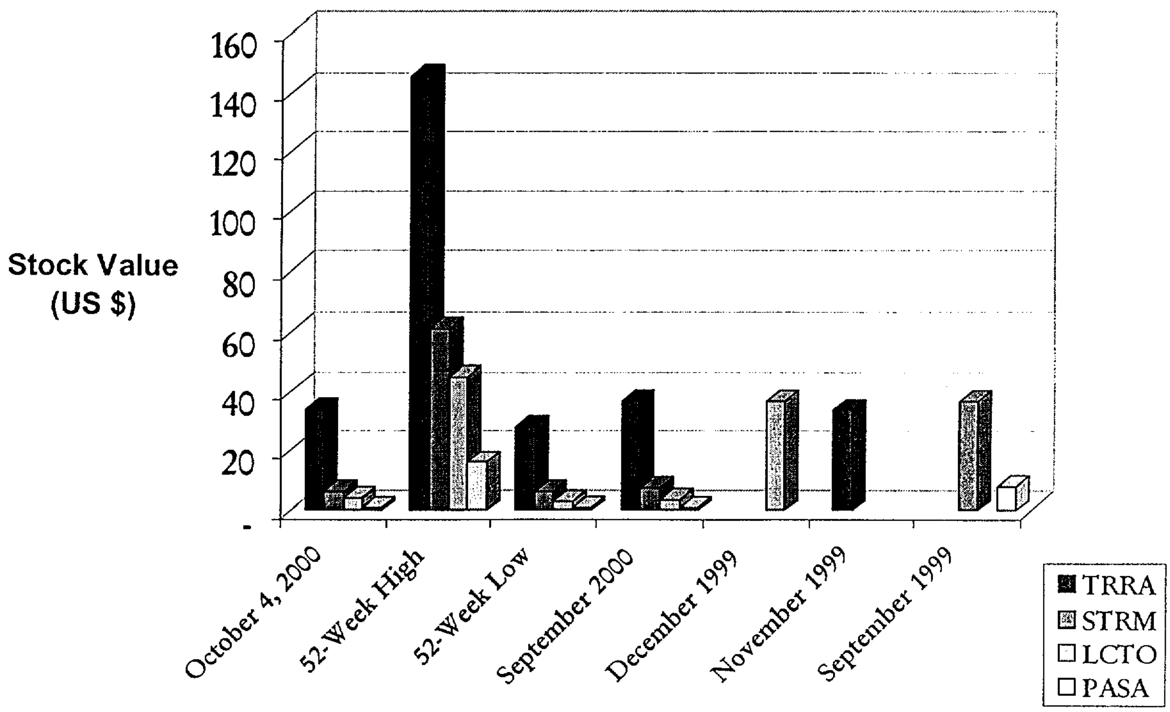
Source: Morgan Stanley Dean Witter

The long standing growth in the United States equity market was the last and perhaps most decisive factor in the growth of the Internet in Latin America.

Stock Performance



Stock Performance



As the stock performance charts show, the Internet boom in Latin America was also nurtured by the enduring period of growth in the United States capital markets.

As the three factors feed back on each other, the conditions for the explosive growth in the Internet services were met. These, as we all too well know, are a secure investment climate and enhance the development of the information infrastructure and consumer demand.

III. CONDITIONS TO SUSTAIN THE PAST GROWTH: A NEW INVESTMENT MODEL FOR GOVERNMENTS AND THE BUSINESS COMMUNITY

While the set of conditions that nurtured the explosive growth in Latin America cannot be extended over the next decade, the region could achieve a sustainable pattern of industrial development through deliberate and harmonized action by public policy makers, service providers and investors.

The Public Policy Agenda to Sustain Internet Growth

From the public policy point of view, governments need to persist in the reform path concentrating in those aspects of public policy that would sustain Internet growth while incorporating the social agenda so that the next boom touches the daily lives of as many citizens as possible. These aspects roughly are:

Savings

More incentives to savings have to be set in place, so as to enhance the domestic resource pool for investments in Internet services. Establishment of pension funds, development of tax credits fostering incubator activities and simpler taxation codes and lesser taxation burdens to reduce evasion are the logical next steps to further economic reform.

Education

- **International Financial Assistance to Rebuild the Education Infrastructure**

  Education infrastructure should be prioritized in loan agreements with multilateral financing institutions such as the IDB and the World Bank. Partnerships among authorities and the private sector should be encouraged by loan agreements so as to speed the rate of development of the education infrastructure.

- **Partnerships with the Business Community to create Knowledge Driven Societies**

  The current pace of educational reform is truly disappointing because, except for Mexico, Argentina, Chile and more recently, Brazil, most authorities in the region seem to ignore the powerful impact that new technologies can have in improving teaching skills at the Primary school level. To be sure, satellite based digital television, broadcast television and the Internet could become a powerful tool to train teachers in state-of-the-art learning methods. Distance learning is one click away from classrooms but needs government support in building the infrastructure and providing schools with the equipment to receive this cost-effective training. Current philanthropic efforts by private entrepreneurs are making a significant albeit limited impact in promoting education reform. These efforts need to be encouraged and supported by the authorities so that they can expand and reach all primary schools in Latin America.

- **Promoting Training**

  Business loans and tax credits should be used as incentives to increase training efforts by the private sector so as to reach the target of investing 15% of companies' budgets in training efforts by the year 2005.

- **Credit**

  To enhance the available pool of credit more needs to be done in terms of encouraging the development of capital markets. Transparency and consolidation rules and competition watchdogs should be set in place to encourage foreign investment in local capital markets and the development of sounder and faster growth of financial systems.

- **Information Infrastructure**

  Development of community based Internet access provision centers and wiring of schools must proceed at a faster rate in the region to universalize usage of this medium and create an information savvy culture. Incentives in the form of usage of international loans to the establishment of small credit granting institutions to finance the acquisition of computer hardware in partnerships with computer manufacturers should be established. These measures would improve access to the information economy to low-medium and low-income households.

- **Winning Investment Models for Businesses**

  From the private sector perspective, three developments are bound to shape future growth in the Latin American Internet Economy. First, the development path of the telecommunications industry that is the backbone for the Internet economy. Wireless applications are the most likely leaders in the field. To be sure, cellular phone usage in Latin America is projected to reach 60 million subscribers by the year 2003. Enhanced market penetration would thus need to factor in this important consumer niche. Second, as Internet usage by large business concerns reaches maturity, content and access providers need to tap the unexplored source of growth represented by small and medium size enterprises. For these ventures the Internet holds the promise of delivering the means to meet international productivity standards by providing back office services, on-line banking, and means to procure and to distribute at cost effective rates. Also as competition mounts in the brick and mortars industries, acceleration of their modernization pace will become essential for survival. This will enhance demand for links to the Internet economy. Third, the severe correction experienced by the capital markets this year signaled the end of the bull market and that of the so-called eyeballs driven investment model. While horizontal portals enjoyed a flurry of investment resources, high burn rates and invisible profitability are not sustainable in a world where equity based gains are lower and investors are more demanding and choosy. Thus business models in the Internet are bound to experience severe change to favor economic efficiency and productivity gains.

In light of these new set of conditions, one can reasonably expect that growth in the Internet economy will be driven by consolidation among the existing horizontal portals with those with strong brands, deep pockets, and with unique, appealing and imposing contents. Competition among these leaders will be fierce with new services and constantly improving content offerings entering the market to secure consumer loyalty. Winning investment models will include those that aim at establishing:

- Links between the brick and mortars and the Internet economy
- Broadband and Wireless technology applications
- Convergent information and entertainment services
- Niche-oriented content
- Interactive, TV based e-commerce platforms
- Internet based services to improve productivity and reduce operating costs
- Internet centric approaches to distribution, marketing and procurement activities