Financing innovation in small businesses and start-up firms: policy issues

José Palacín
Economic Cooperation and Integration Division
United Nations Economic Commission for Europe

Minsk, Republic of Belarus, 12-13 July 2012

Structure course

- Introduction
- The nature and financing of innovative enterprises
- From ideas to start-ups: the role of public initiatives
- Business angels and early-stage financing
- Early-stage growth: venture capital and other financial intermediaries
- Financial development and public financial markets
- Design, implementation and evaluation of early-stage policies
- Recapitulation and conclusions

Module 3

Business Angels and Early Stage Financing

Module objectives

- Understanding business angels
  - Characteristics
  - Decision making
  - Networks
- Nature and operation of corporate VC
- Mechanisms for policy intervention

Who are the business angels?

- (Wealthy) individuals, often cashed-out entrepreneurs
- Make equity investments of $25-50k (up to $1-2m for syndicated deals) in promising ventures
- Provide substantial portion of the seed and start-up capital of innovative enterprises
- Provide more than capital (expertise, support)
- Active & passive; novice & experienced

Business angels

Realisation:

- VC, even with public support, is not a solution for early-stage financing problems
- Business angels are an effective way to explore new ideas
- Europe lags behind the US

BA financing: an EU-US comparison

	European Union	United States
Number of networks	297	245
Number of business angels	75,000	250,000
Investment per round	EUR 165,000	EUR 210,000
Total amount invested	EUR 3-5 billion	EUR 20 billion

Source: OECD

BA activity in some European countries

	Volume invested (thousand EUR)	Number of deals	Number of network members
Austria	600	5	147
Belgium	7,006	35	385
Czech Republic	500	1	41
Finland	5,000	10	458
France	37,000	214	3,600
Ireland	2,200	5	232
Italy	19,500	102	150
Luxembourg	80	2	31
Netherlands	6,200	75	1,904
Portugal	1,662	11	430
Slovenia	280	2	25
Spain	2,526	11	806
Sweden	15,000	99	1,042
United Kingdom	43,084	449	4,991

Source: European Commission, Enterprise Finance Index

Key decision criteria

- Is proposal unsolicited or through referral?
- Does the business have solid fundamentals?
  - Potential market impact
  - Sustainable competitive advantage
- Is the person qualified to run the business?
- Does the business operate in familiar area?
- Is it close enough for face to face interaction?

Business angel networks (BAN)

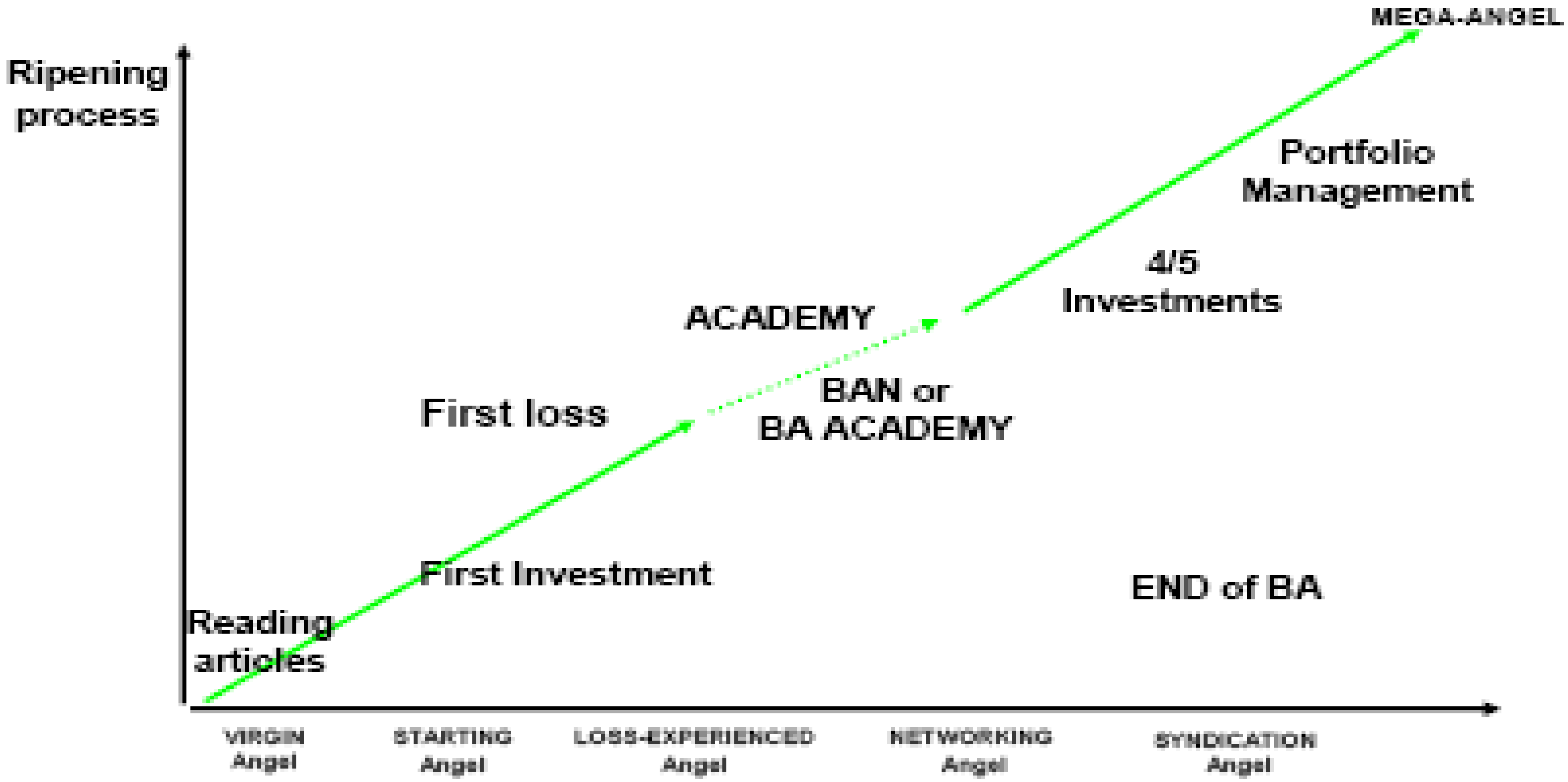
- Pool the financial, knowledge, and information resources of a group of angels
- Alleviate the inefficient flow of information between (individual) angels and entrepreneurs
- Attract bigger deal flow
- Allow individual angels to diversify their portfolios and participate in more deals

The operation of BAN

- Local, regional or national in scope
- Organized around interests in particular sectors
- Offer a number of key services
  - Matchmaking
  - Business plan coaching to entrepreneurs
  - Training to both investors and entrepreneurs
  - Syndication support
  - Co-investment funds and opportunities

BA Training

■ Policy Failure



BAN and Investment Readiness

- Working with entrepreneurs to improve the quality of their business plans
- Aims:
  - Reduce the rate of rejection of projects
  - Ensure that entrpreneurs understand the implications of different types of financing

Angel syndication

The realities of angel syndication	
Benefits	**Drawbacks**
Reducing risk (Portfolio theory)	False sense of security – underestimating risk.
Additional bargaining power and the ability to participate in future rounds.	Makes deals more complex, more formalised, therefore longer decision making, choosier in investments.
Ability to learn from more experienced investors.	Difficulty in working with many different personalities.
	Complications with multiple lead investors.

Source: EBAN

Factors affecting BA investing

- Potential for promising returns
  - Availability of growth capital
  - Lucrative exit routes
- Supply of high quality enterprises
- Tax conditions (tax relief, capital gains tax, dividend tax)
- Economic conditions (growth, interest rates, inflation)
- Stock market conditions

Policy initiatives for BA activity

- Tax incentives
  - Tax rebates or deductions
  - Capital gains tax exemptions or deferrals
- Technical or financial support
  - Establishment of BAN
  - Business angel academies
- Financial leverage
  - Co-investments
  - Capitalizing angel investment funds

Policy tools to foster BA financing

- **Fiscal incentives:** UK, France
- Facilitate creation of **BA networks** and training: widespread support EU/national
- **Cooperation** between BA and other **investors**, including co-investment with the public sector: more recent but supported with EU instruments.

BA promotion

NATURE OF INTERVENTION	OBJECTIVE
Fiscal incentives	Increase the number of business angels and the amounts invested by improving the risk-reward ratio: front-end relief, capital gains relief, rollover relief, equity guarantee.
First generation business angel networks	Facilitate the dissemination of information in the market and the matching of entrepreneurs and investors.
Securities legislation	Changes in legislation that prevented entrepreneurs from circulating “invitations to invest” unless they had been approved by an authorized body.
Capacity building – entrepreneurs	Training for entrepreneurs to improve their investment readiness – usually provided by second generation BANs
Capacity building – investors	Training for investors to increasing their skills in making investments – usually provided by second generation BANs.
Co-investment vehicles	Government-financed venture capital funds which leverage investments made by business angels to increase deal sizes and enable business angel groups to make more investments and follow-on investments.

Example: Enterprise Investment Scheme

- Seeks to help certain types of small higher-risk unquoted trading companies to raise capital

- Provides the following reliefs to investors:
  - Income tax rebate equal to 20% of investments up to £400,000.
  - Income tax relief of 40% on failed investments
  - Deferral of tax on capital gains if these are reinvested in EIS companies.

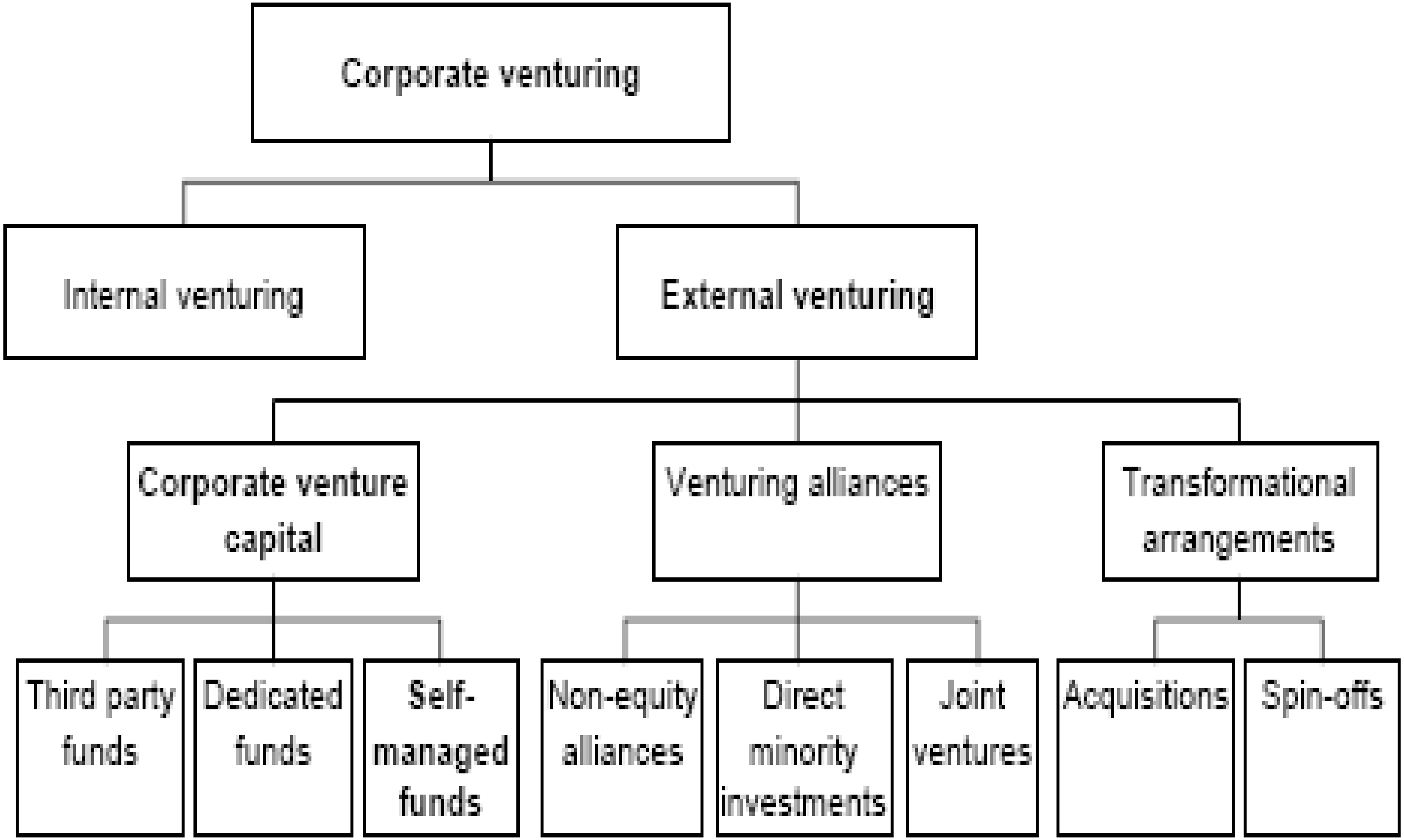
BA financing – Major trends

- Local but transnational – the EU EASY project
- Importance of syndication and co-investment – larger size deals, follow-on investments – use of EU instruments
- Exit routes – collaboration with other investors

Corporate venture capital

- Equity investments by subsidiaries of non-financial corporations
- Alternative source of SME financing
- Focus on strategic value, not just financial returns
- A form of business intelligence
- Important for countries with economies in transition, with little BA/VC tradition

Types of corporate venturing



Source: Keil (2000)

Why do companies invest in CVC?

Financial gains	
Market-level learning	Monitoring and exposure to new technologies, markets and business models
Venture-specific learning	Ex. External R&D, manufacturing processes
Indirect learning	Management training, contacts, learning about VC
Options to acquire companies	Identify and assess potential acquisition targets
Options to enter new markets	Accelerated market entry, option to expand
Leveraging own technologies and platforms	Increased demand for technology and products, standard development, shape markets
Leveraging own complementary resources	Add new products to existing distribution channels, utilize excess plant space, time and people

Source: Adapted from Maula (2007)

Initiatives to encourage CVC

- Tax incentives for investments in private, innovative enterprises
- Public-private partnerships
- Establishment of structures that facilitate the incubation of new ideas

Example: Corporate Venturing Scheme

- Introduced in 2000 to encourage venture capital investments by corporations.
- Eligibility criteria
  - Stake not larger than 30%
  - The recipient's assets should not exceed £15 million.
- Tax incentives
  - 20% corporate tax deduction for investments held for a minimum of three years
  - Tax deferral on gains on disposal
  - Relief against income for any capital losses on disposal

Example: “Partner for Innovation”

- High-Tech Start-Up Fund as a public-private partnership with major industrial corporations
- Explicit focus on seed and start-up stages
- Offers VC investments (up to €500,000) to founders of technology start-ups (mainly spin-offs from public research institutions)
- The private partners provide not only funds but also networks for the start-up companies.

Example: Industry Incubator Programme

- Incubators are linked to a well established manufacturing company or a group of companies ("the mother company")
- The mother company offers physical premises and assistance to individuals willing to start up a relevant business.
- Industry incubators are also open to other investors
- Main functions
  - Identify and support new business opportunities
  - Identify people who are interested in them and are capable of developing them.

Corporate Venture Capital as an Exit Mechanism

- Important for particular industries
- Capital intensive industries – incumbents have been a traditional exit route for investors
- Example: biotechnology and pharmaceutical companies
- Counterxample: clean technologies