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

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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
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

<table>
<thead>
<tr>
<th></th>
<th>European Union</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of networks</td>
<td>297</td>
<td>245</td>
</tr>
<tr>
<td>Number of business angels</td>
<td>75,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Investment per round</td>
<td>EUR 165,000</td>
<td>EUR 210,000</td>
</tr>
<tr>
<td>Total amount invested</td>
<td>EUR 3-5 billion</td>
<td>EUR 20 billion</td>
</tr>
</tbody>
</table>

*Source: OECD*
### BA activity in some European countries

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

*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
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 entrepreneurs understand the implications of different types of financing
## Angel syndication

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

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.
<table>
<thead>
<tr>
<th>NATURE OF INTERVENTION</th>
<th>OBJECTIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal incentives</td>
<td>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.</td>
</tr>
<tr>
<td>First generation business angel networks</td>
<td>Facilitate the dissemination of information in the market and the matching of entrepreneurs and investors.</td>
</tr>
<tr>
<td>Securities legislation</td>
<td>Changes in legislation that prevented entrepreneurs from circulating “invitations to invest” unless they had been approved by an authorized body.</td>
</tr>
<tr>
<td>Capacity building – entrepreneurs</td>
<td>Training for entrepreneurs to improve their investment readiness – usually provided by second generation BANs</td>
</tr>
<tr>
<td>Capacity building – investors</td>
<td>Training for investors to increasing their skills in making investments – usually provided by second generation BANs.</td>
</tr>
<tr>
<td>Co-investment vehicles</td>
<td>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.</td>
</tr>
</tbody>
</table>
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

- **Corporate venturing**
  - **Internal venturing**
  - **External venturing**
    - **Corporate venture capital**
      - Third party funds
      - Dedicated funds
      - Self-managed funds
    - **Venturing alliances**
      - Non-equity alliances
      - Direct minority investments
      - Joint ventures
    - **Transformational arrangements**
      - Acquisitions
      - Spin-offs

Source: Keil (2000)
# Why do companies invest in CVC?

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

*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
- Counterexample: clean technologies