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 4

Early-stage growth: Venture Capital and Other Financial Intermediaries

Module objectives

- Understanding the venture capital cycle
  – Nature and operation of VC funds
  – Best practices of VC fund management
  – The levers of the VC investment process
- The role of traditional financial intermediaries
- Mechanisms for policy intervention

Financing early-stage growth

- Capturing commercial potential requires
  - Financial, managerial, and technological resources
  - Managerial and strategic expertise
- Hurdles faced by new ventures
  - Where and how to compete?
  - Acquiring customers
  - Establishing relationships with suppliers
  - Hiring personnel

The intermediary function of VC firms

- Channel funds from institutional investors to high-potential enterprises
- Provide specialized investment expertise
  - Identify potential investments
  - Monitor, provide financing in stages
  - Add value through oversight and guidance
- Depend on smooth flow of funds from institutional investors and back (with returns)

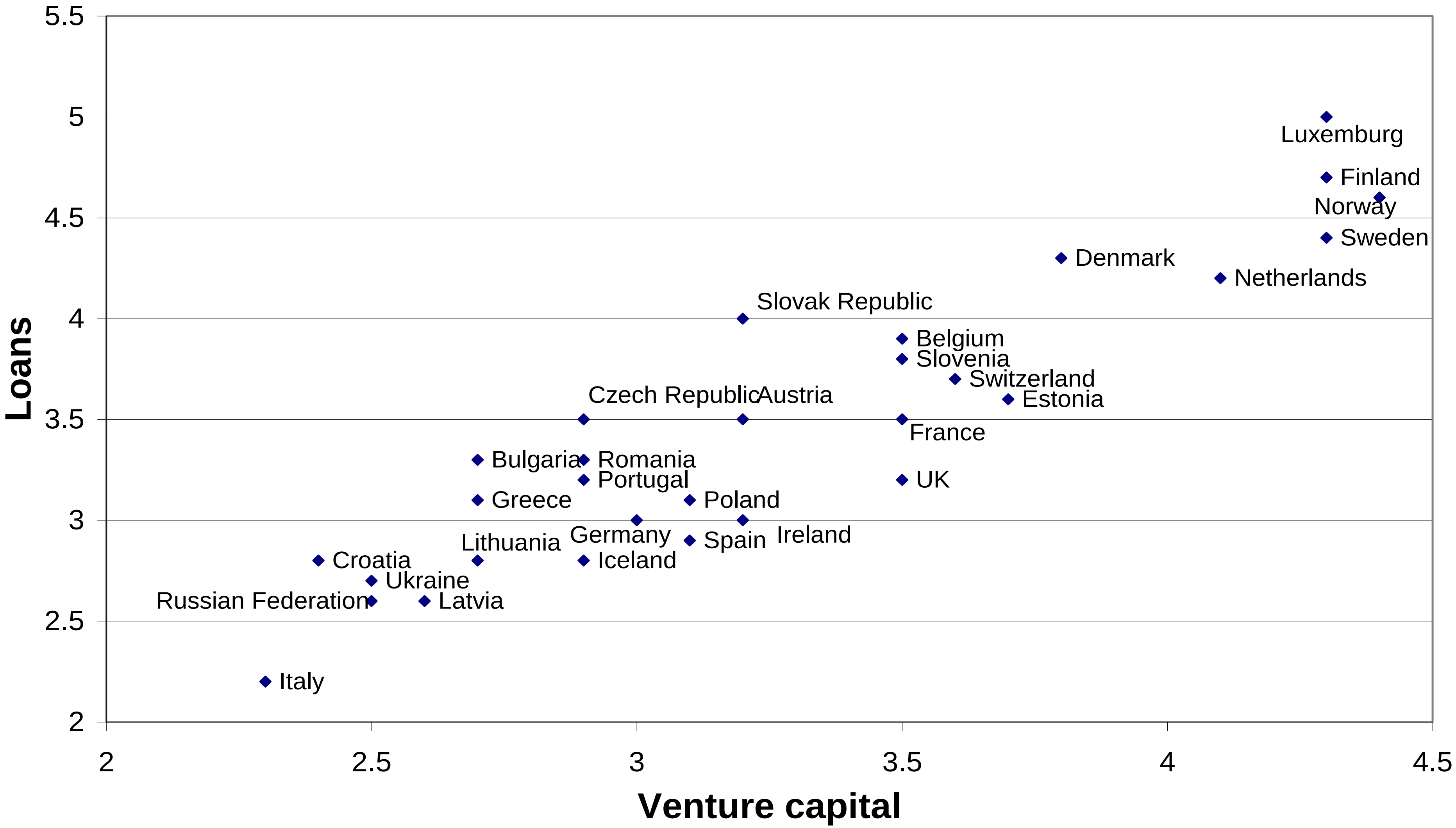
A note on terminology

- Private equity - provision of equity capital to enterprises not quoted on a stock market.
- Venture capital – provision of equity capital for the launch, early development, or expansion of a business (i.e. a subset of private equity)

Overview of venture capital

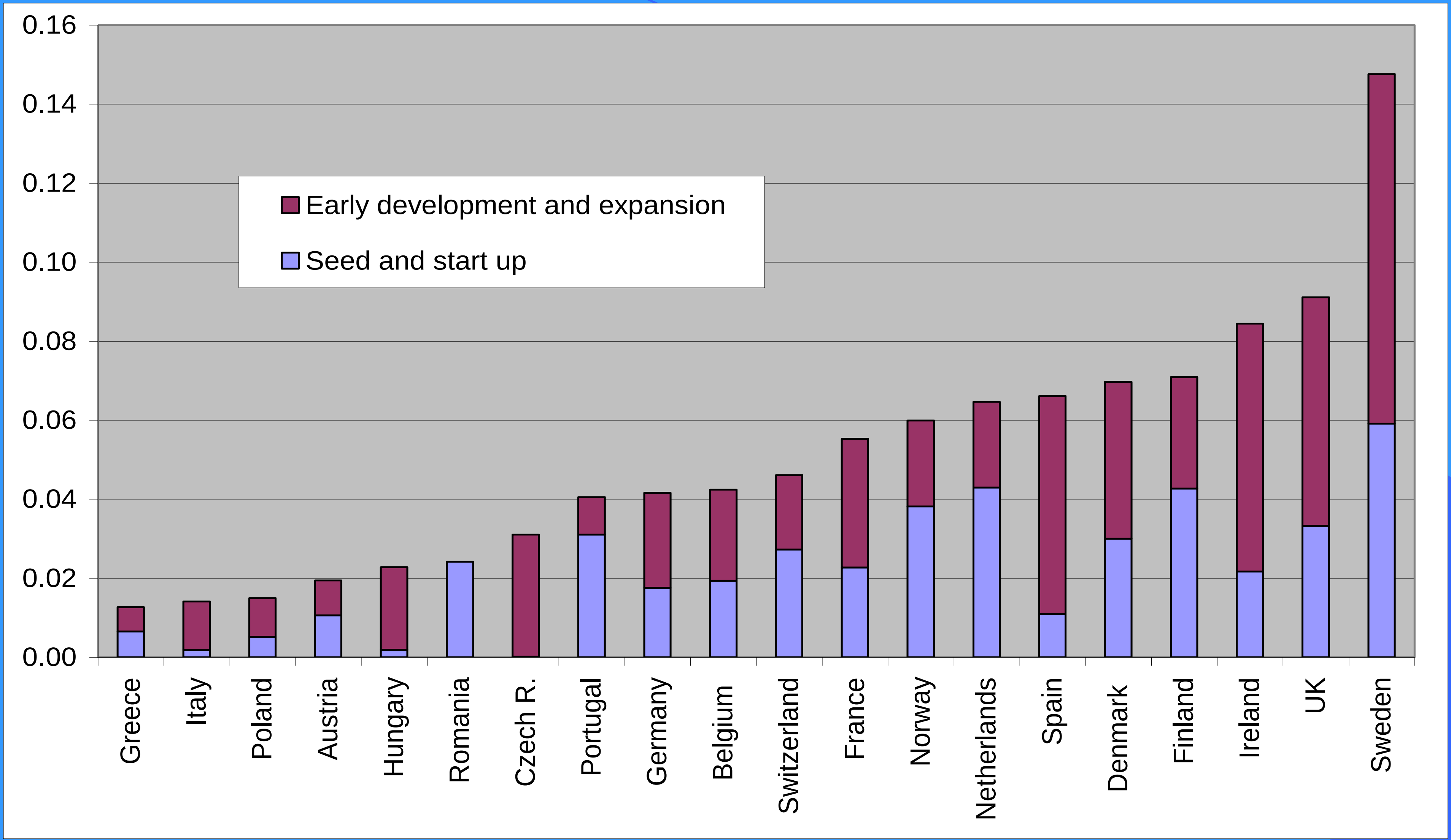
- Provision of professionally managed equity capital to promising enterprises
- Anticipation of exit (liquidity event) in 5-7 years
- “Patient” capital – illiquid before exit
- The bulk (70-80%) goes to early-growth or expansion-stage companies

European diversity



Source: WEF

Venture capital landscape



Source: EVCA

Limitations venture capital

- Scarce presence in early-stage financing (high risk, small deal size)
- Poor investment record of European VC funds in early-stage

Investment by stage of development

As percentage total PE

	2007	2008
Seed	0.2	0.6
Start-up	3.2	4.6
Later stage venture	7.5	7.9
Total Venture	10.9	13.1

Source: EVCA

Internal rate of return

Cumulative Fund Type Performance (end 2008)

	Sample size	Pooled average
Early-stage VC	**351**	**-1.3**
Development stage VC	219	7.4
Balanced VC	204	3.0
All Venture	**774**	**3.0**
All Buyout	431	13.0
Generalist	126	9.0
All Private Equity	**1,331**	**9.5**

Source: EVCA

How does a VC fund work?

- Typically structured as LLP
  - Fund investors are limited partners (i.e. prohibited from active engagement)
  - VC firm manager(s) act as general partners and are responsible for all investment decisions (subject to some contractual limitations)
  - Fixed-term life, typically 10-12 years
- Fees and compensation
  - Management fee, 2-3% of fund capital
  - Carried interest - 20-30% of excess returns
  - Strong incentive to increase the upside

Advantages of the LLP structure

- Avoidance of double taxation – distributions flow through and are taxed at the limited partners
- Securities can be transferred to the limited partners without tax liability until they are sold
- Transfer of stakes and early withdrawals are prohibited
- Automatic dissolution at the end of its term

How do VC firms add value?

- Provide incentives
  - Capital provision linked to achievement of milestones
  - Entrepreneurs retain the the residual value
- Provide expertise
  - Discern opportunities and threats
  - Operational and strategic guidance
  - Professionalization of management
- Provide network and legitimacy
  - Lend extensive network of relationships
  - Ease the concerns of customers or suppliers

Taxonomy of VC funds

- Public vs. private
- National vs. regional
- Captive vs. independent
- Fund-of-funds
- Sidecar funds

VC investment process

- Pre-investment
  - Origination, prospecting
  - Screening and due diligence
  - Structuring
- Post-investment
  - Monitoring and oversight
  - Value adding
  - Exiting

Investment decision considerations

- Initial screening
  - Does it meet the fund's basic investment criteria?
  - Is there a personal referral?
  - Quality of the business plan (executive summary)
- Detailed evaluation
  - Potential market impact
  - Strength of competitive position
  - Management team quality
- Due diligence
  - Third-party opinions on underlying technology
  - Corroboration of estimates and assumptions

Sample VC financing Process

- Analysis Process
- Exclusivity Period (3 months)

Deal Generation → Pipeline Process → Internal Due Diligence → **Non Binding Offer** → Due Diligence Process → Final Process

- 2weeks-1month
- "Mini Due Diligence Process"
- NDA: Non Disclosure Agreement

- Information to the Investment Committee.

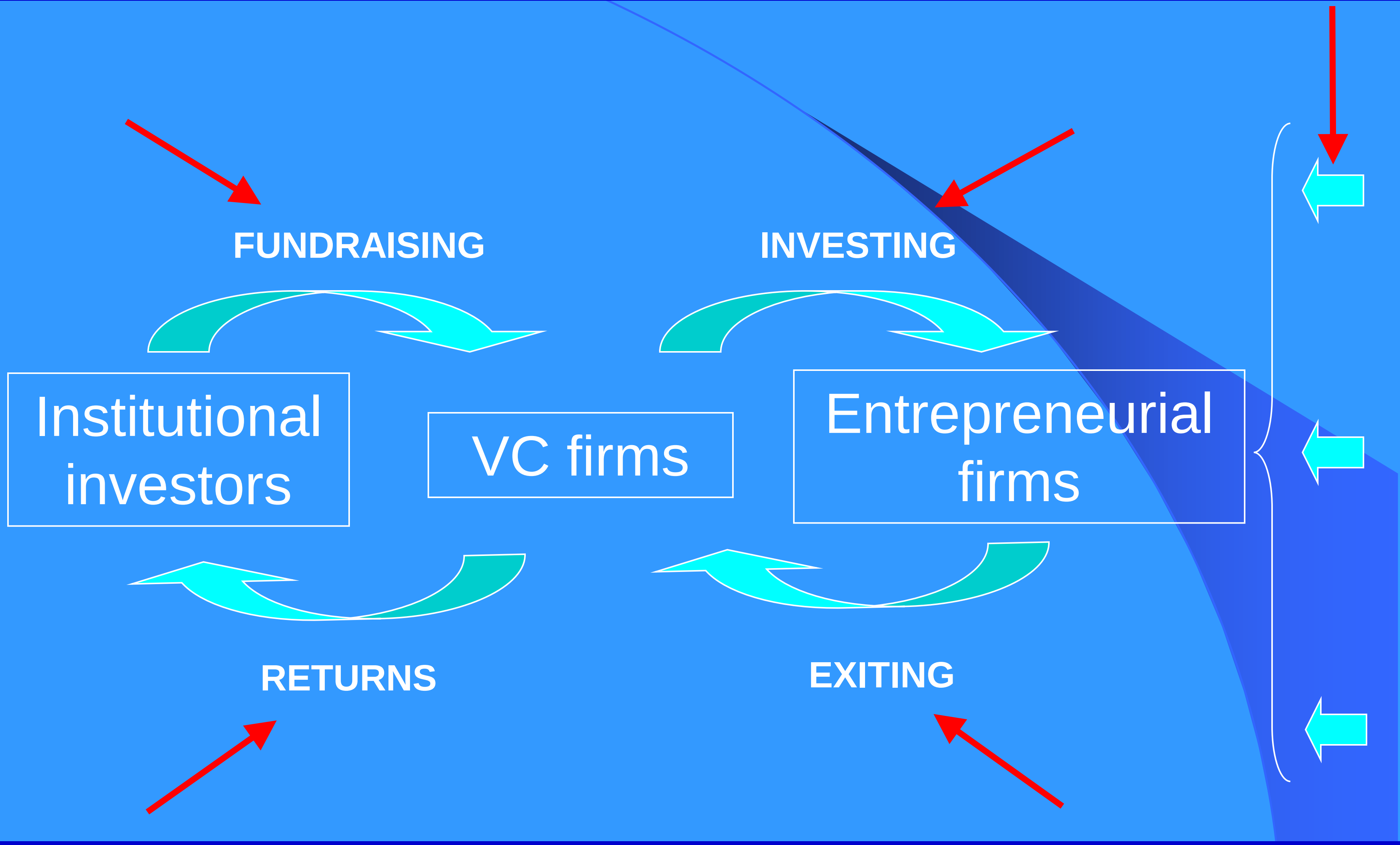
- DD+Legal Contracts

- If what you say is true, I will be able to pay you… $/.

Good practices of VC fund management

- Proper structure for patience and performance incentives
- Long-term relationships with institutional investors
- Entrepreneurial and relevant industry experience of the VC managers
- Retention of in-residence industry experts
- Use of convertible preferred stock
- Manageable number of companies to oversee
- Long-term relationships with investment banks

The levers of VC finance



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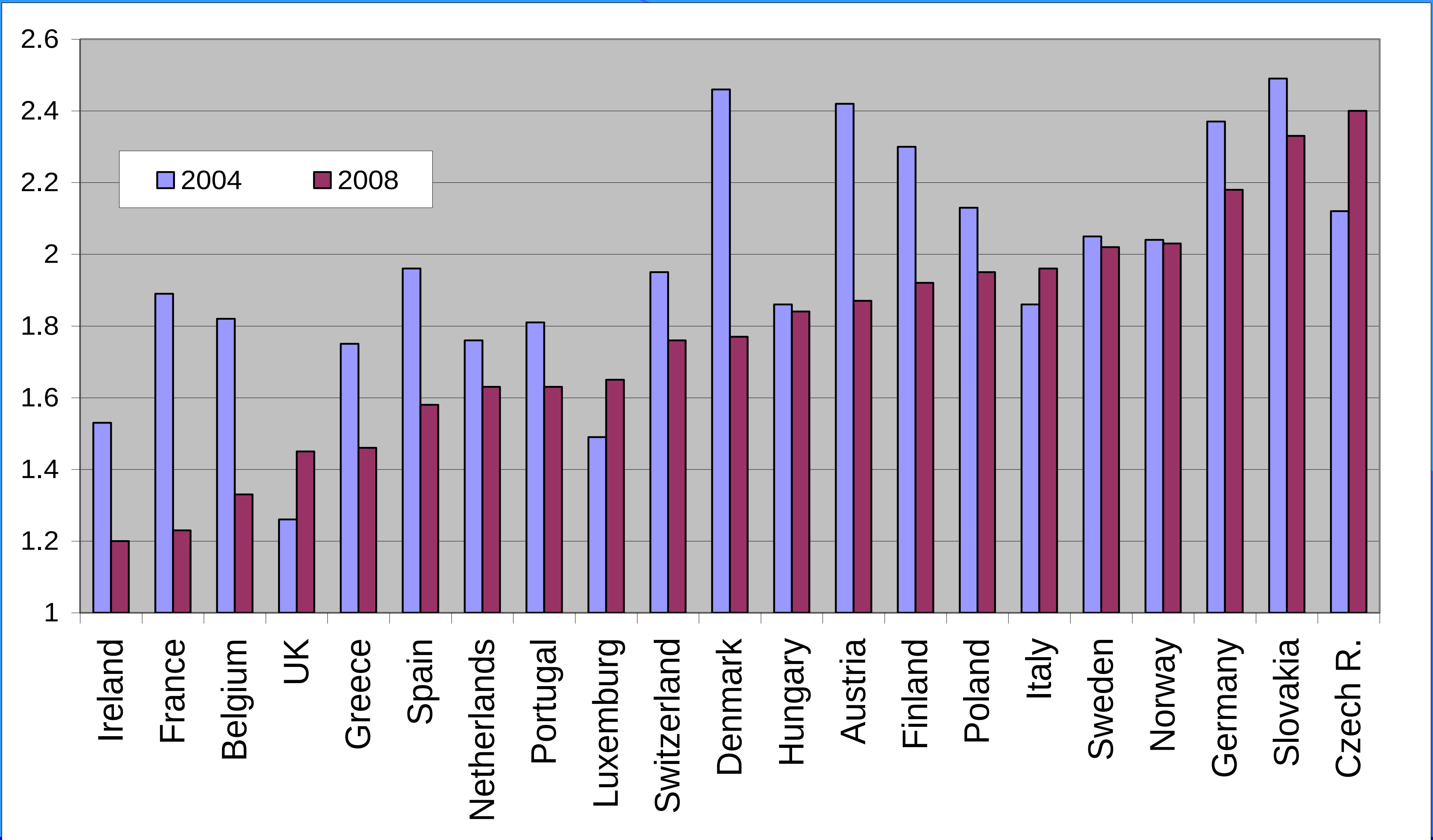
Tax and legal environment



Source: EVCA

Issues in fundraising

- Enticing institutional investors
  - Education on VC nature and return profile
  - Qualms about new funds, new managers
  - Natural cycles of ebbs and flows
- Tax issues
  - Existence of dedicated or suitable structure
  - Exemption for cross-border fundraising
  - Capital gain taxation
- Regulatory issues
  - Restrictions for “alternative” asset classes
  - “Safe haven” and “prudent man” rules

Issues in investing

- Availability of investment opportunities
  - R&D environment
  - Entrepreneurship as a career option; relevant education
  - Availability of financing at earlier stages (grants, BA)
- Recognition and selection of opportunities
  - Support network for deal referrals and due diligence
  - Industry specific skills and connections of VC managers
  - Proper risk-return profile
- Effective contracts
  - Tax treatments of convertible preferred stock
  - Rule of law in enforcing contractual provisions

Government intervention

Direct – Public resources invested by public servants.

<u>Examples:</u> Finish Investment Industry Programme, Danish Business Development Finance

<u>Problems:</u> Incentives and expertise

Indirect- Harnessing private expertise in the investment process

But does this expertise exist?

Hybrid funds

Public private-partnerships are the dominant form of intervention:

Pari passu – benefits for private sector: certification effect, building a track record, lower due diligence and setting up costs

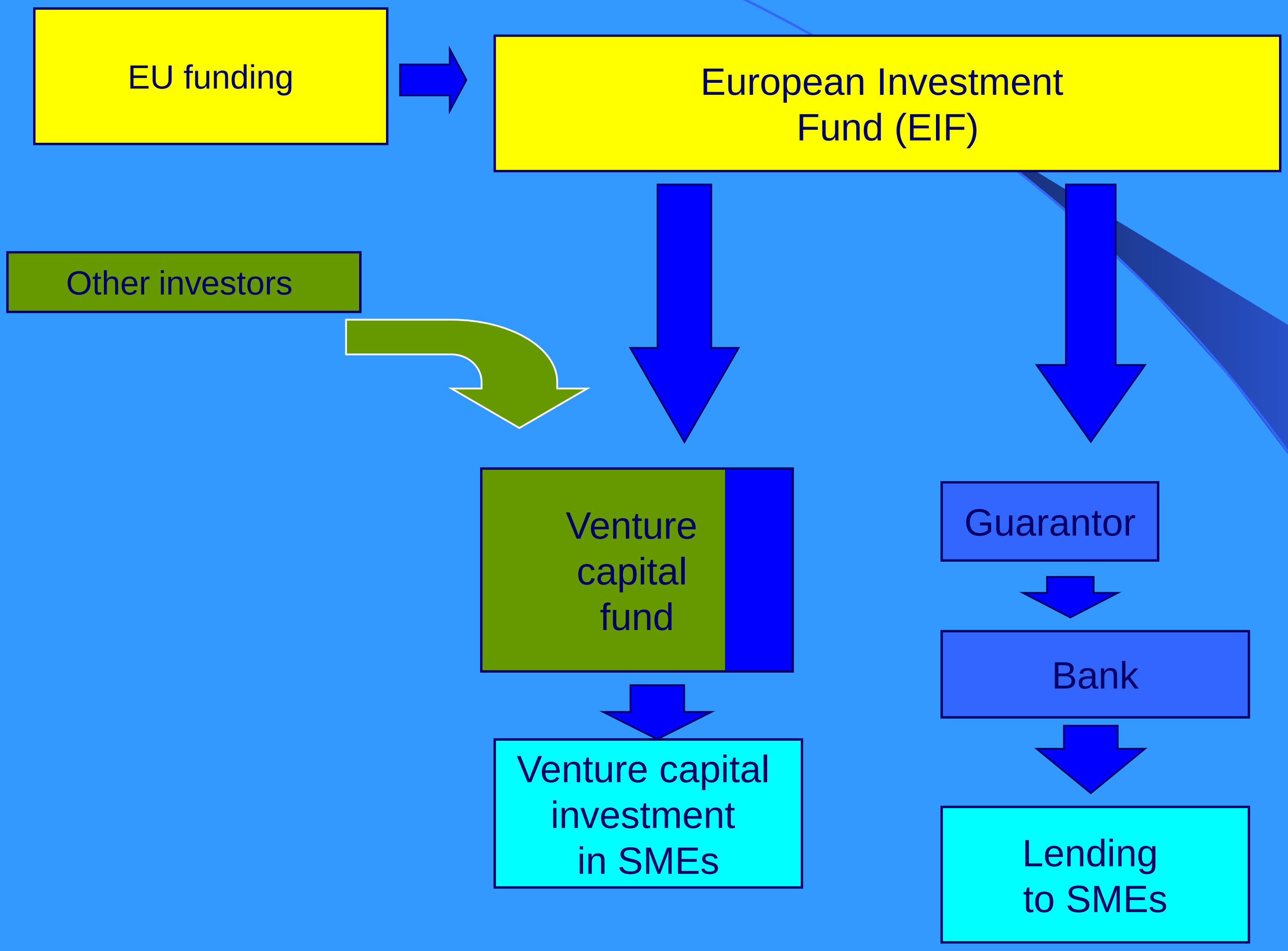
Asymmetric sharing of risk and rewards

Fund –of-funds structures are popular

Types of hybrid funds

- Co-investment private-public – European Investment Fund
- Capped returns for public investors
- Buy-option for private investors
- Fund operating costs
- Timing of cash flows
- Downside protection

Competitiveness and Innovation Framework Programme



Issues in value adding

- Incentives to provide value added
  - Stake in the upside
  - Loss guarantees can be counter-productive
  - Leveraging of lower-cost, public funds
- Ability to provide follow-on financing
  - Small funds can be diluted in later rounds
- Possession of proper skills by the VC investors
  - Career paths from high-technology settings
  - Mobility of managers across firms and countries

Downside protection

- Popular but problematic, given its impact on incentives
- Keeping the upside better than protecting in the downside to attract the right calibre of managers
- Examples: Germany KfW Venture Capital Programme, SOFARIS in France

Developing the industry

- Publicly-sponsored public sector provide a **training ground** to develop skills.
- This is clearly understood in European countries with **less developed VC** sectors.
- **EU: Capacity Building Scheme** to improve the investment and technology expertise of funds.

Issues in exiting

- IPOs and trade sales are most lucrative routes
- Returns are sensitive to 1-2 big hits
- Successful IPOs require active stock markets, open to new securities
- IPO windows are sensitive to economic conditions (e.g. 2008-2009)

Challenges for traditional banks

- Lack of tangible assets (collateral)
- Volatility in cash flows
- Lack of historical operating performance
- No gain from the enterprise success, beyond the repayment of principal and interest
- Need to align the risk-return parameters (credit enhancement)

Forms of credit enhancement

- Provision of guarantees
  - Promise to reimburse lenders for losses up to pre-specified amounts
  - Enterprises can use guarantees to obtain financing
  - Enterprises pay premium for the guarantee
  - Pre-specified parameters (e.g. amount, time)
- Counter-guarantees or co-guarantees
- Securitization (asset-backed securities)
  - Pooling of risks
  - Transfer of risks to separate entities

Challenges to administering guarantees

- Eligibility criteria need to be clearly specified
- Need for rigid and effective selection methods to ensure properly motivated entrepreneurs