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Financing for Innovative Young Firms and the Role of Policy

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.

BETTER POLICIES FOR BETTER LIVES

Financing for Innovative Young Firms and the Role of Policy

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Policy Rationales for Intervention

- Policy rationales for intervention in seed and early stage finance
  - Financing gaps and market failures (information asymmetries)
  - Spill-over effects (job creation, economic growth)
  - Part of a broader economic development strategy
- Supply versus Demand side interventions
  - The majority of focus remains on the supply side
    - Visible programmes demonstrating that action is being taken.
  - However, demand side interventions are increasingly important
    - Shortage of innovative entrepreneurs willing and able to start and grow companies.
    - Lack of experienced investors, particular in equity investment.

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Types of Financing Interventions

(Supply Side)

- Grants, Loans and Guarantees
  - Grants (including SBIR type)
  - Loans
  - Guarantee schemes
- Fiscal/tax incentives
  - Young innovation company schemes (YIC)
  - Tax incentives on investment ("front-end")
  - Tax incentives on capital gains ("back-end")
- Equity funds (VC and angel)
  - Public
  - Fund of funds
  - Public/private co-investment funds

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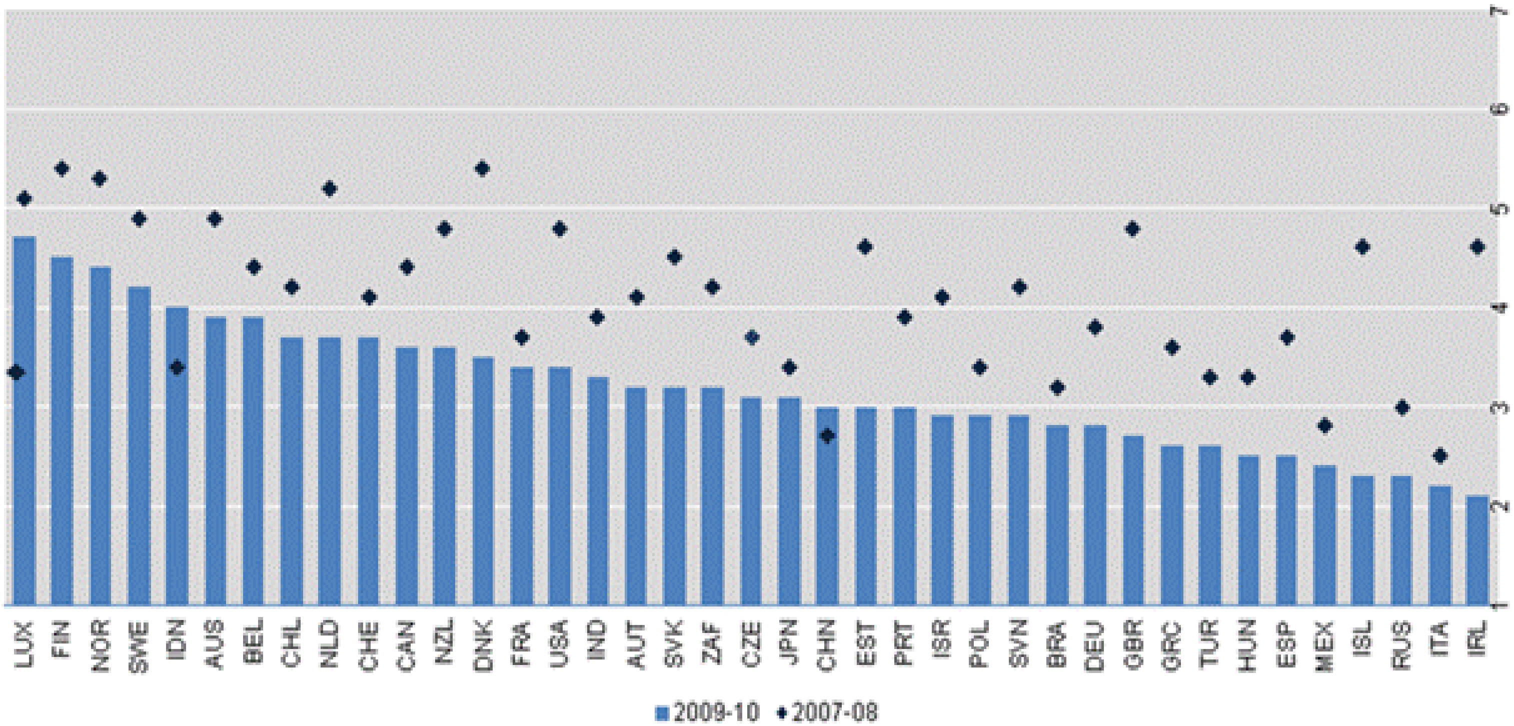
Access to Debt Financing Has Become More Difficult

Ease of access to loans, 2007-08 and 2009-10

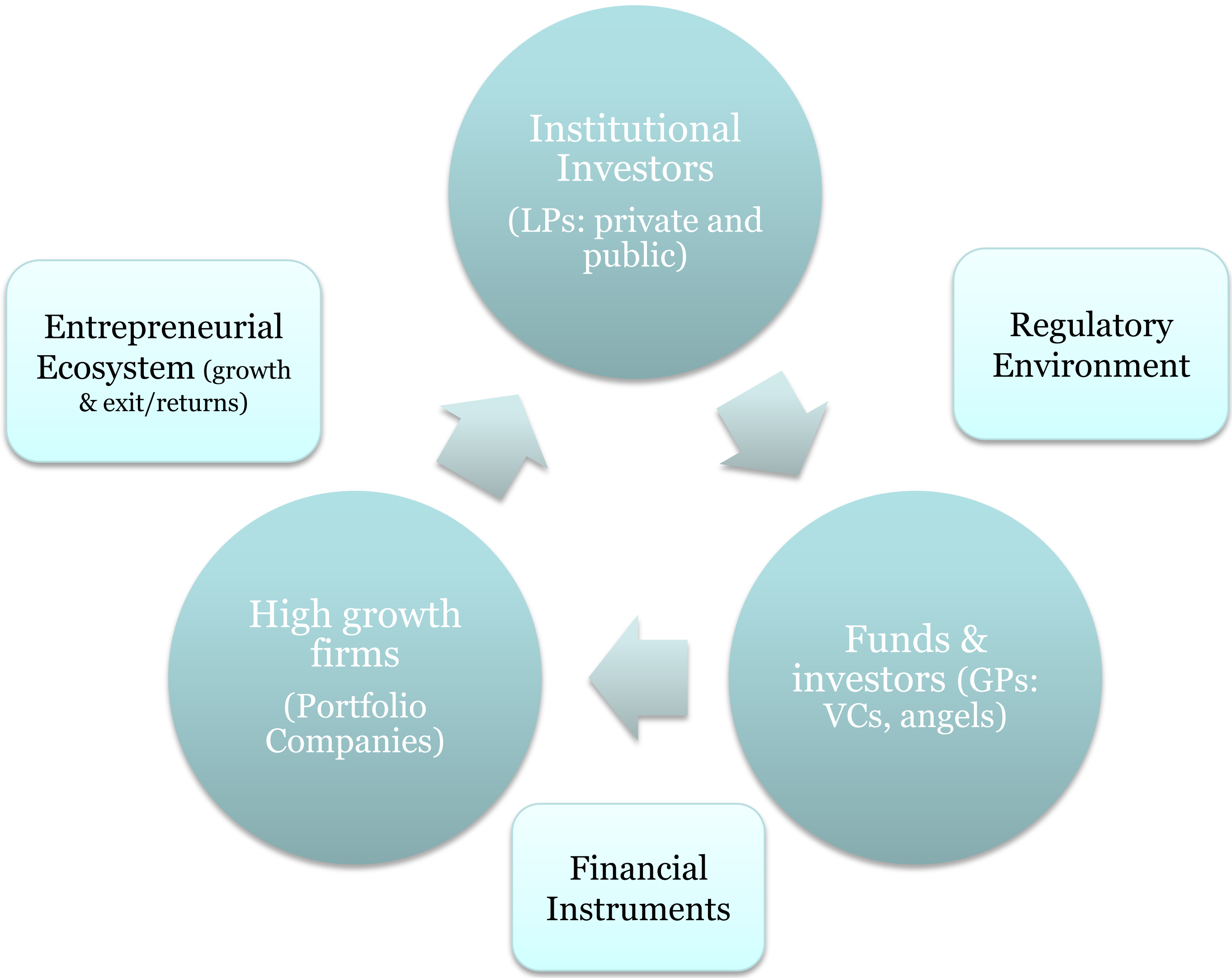


Note: Scale from 1 to 7 from hardest to easiest, weighted averages.

Source: World Economic Forum (2010), The Global Competitiveness Report 2010-2011 and
World Economic Forum (2008), The Global Competitiveness Report 2008-2009, World Economic Forum

Equity Financing Cycle (for HGFs)

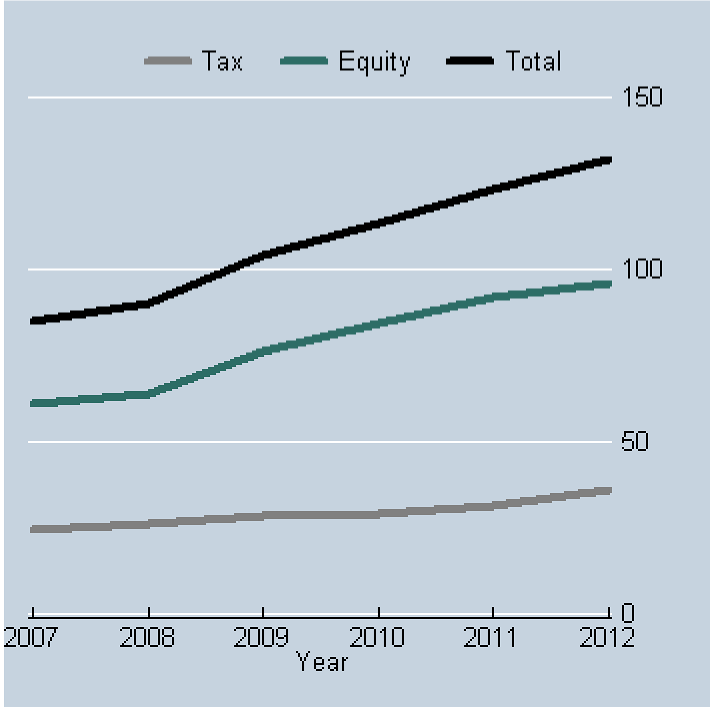
What is the role and impact of
policy intervention?



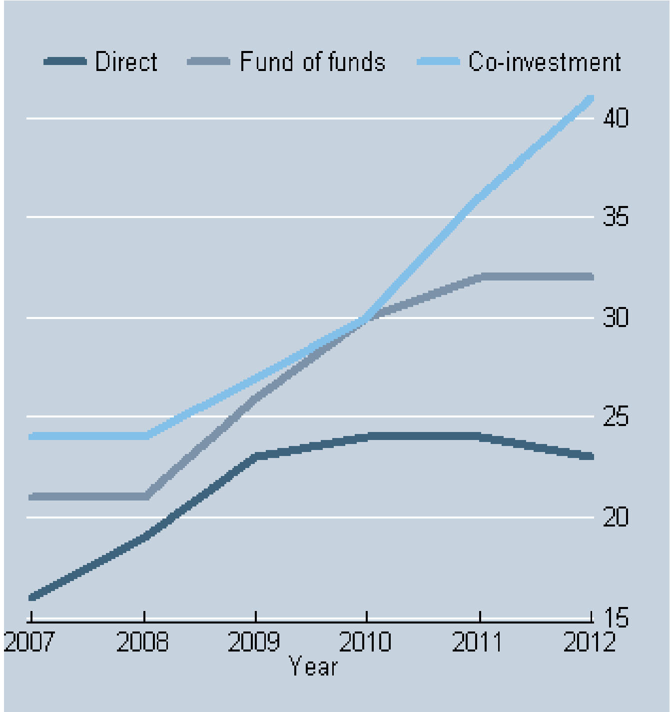
Number of Tax & Equity Instruments

(2007-2012)

Equity relative to tax instruments



By type of equity instrument



Note: These statistics do not reflect amounts committed or invested through the programmes.

Source: 2012 OECD Financing Questionnaire and OECD Secretariat research

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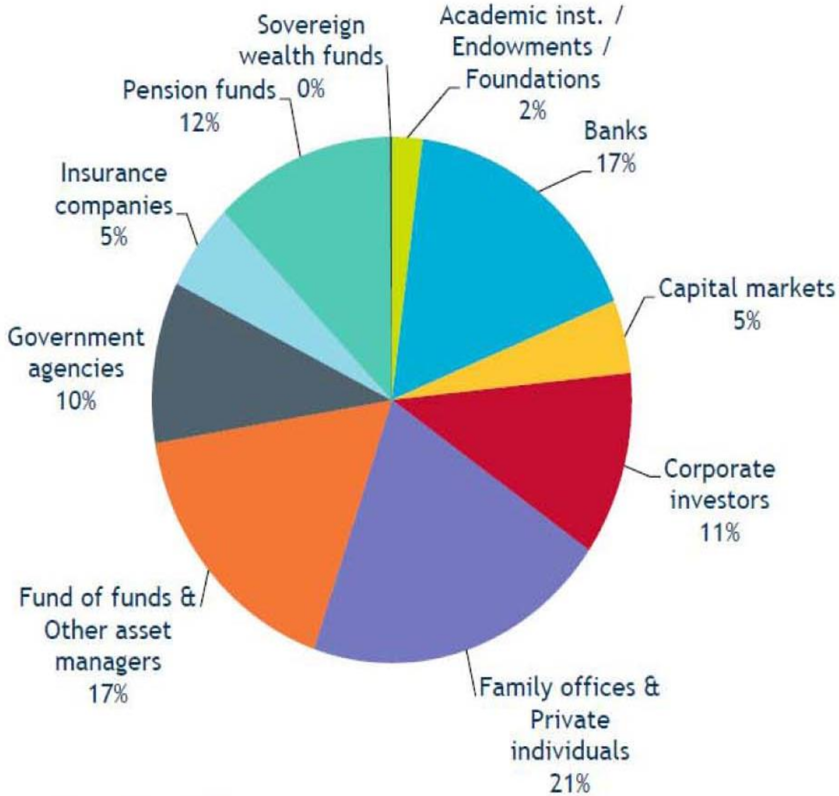
Growing Role of Government

Venture Funds Raised in Europe by Type of Investor

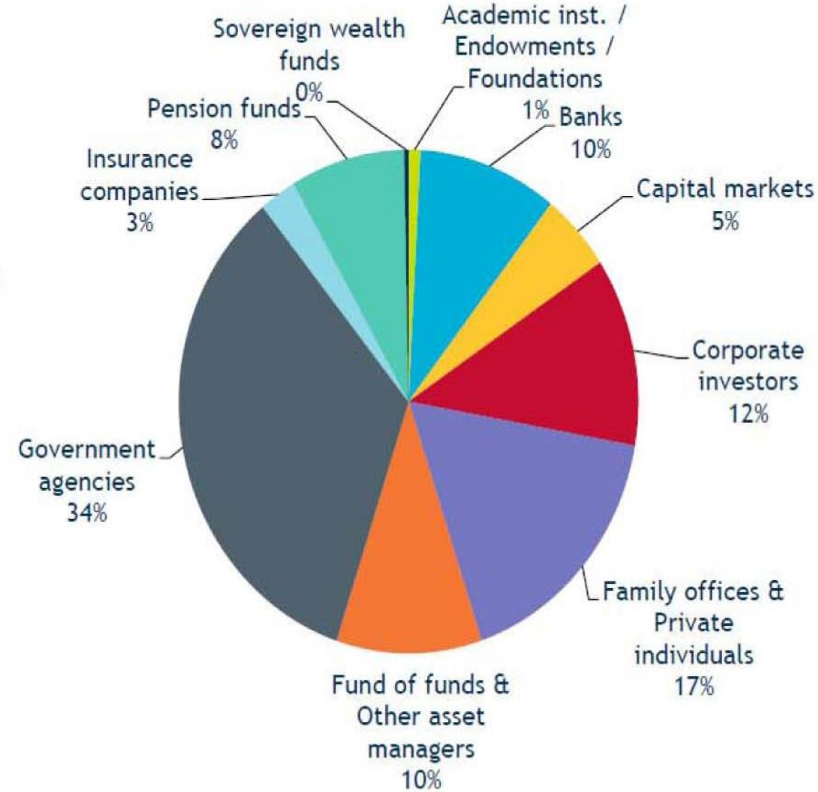
2007

EUR 8.4B
(0.84B from gov't agencies)



2011

EUR 4.9B
(1.67B from gov't agencies)



Note: 2007 vs 2011 – Incremental amount raised during the year as a percentage of total amount

Source: EVCA PEREP Analytics.

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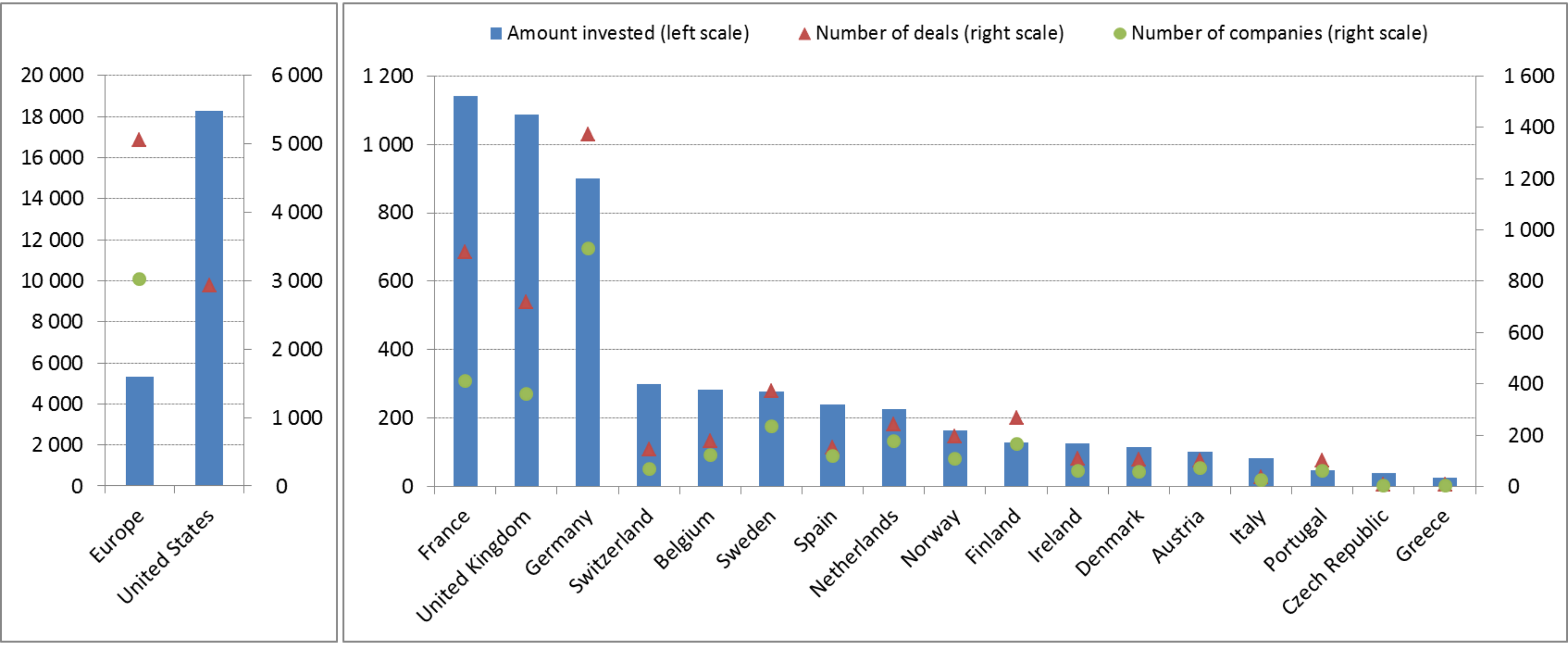
Venture Capital Investments in 2009 Europe compared to U.S.

(USD million)



Source: OECD based on industry statistics by EVCA/PEREP Analytics and PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report data.

Angel Investors Play a Key Role

- However, many government programs addressing seed and early stage finance focus on VC rather than angel investment.
  - In some countries, the ***amount of angel investment is estimated to be significantly larger than VC***.
  - VCs have moved to later stages of financing, angel investors have been filling the growing seed & early stage funding gap through the creation of syndicates, groups and networks.

Equity Investors at the Seed, Early and Later Stage of Firm Growth

<table>
<tr><th colspan="3">INFORMAL INVESTORS</th><th colspan="2">FORMAL INVESTORS</th></tr>
<tr><td>Founders, Friends and Family</td><td colspan="2">Angel Investors
(typical investment size: 25-500K USD)</td><td colspan="2">Venture Capital Funds
(typical investment size: 3-5M USD)</td></tr>
<tr><td colspan="2">Seed Stage investments</td><td colspan="2">Early Stage Investments</td><td>Later Stage Investments</td></tr>
</table>

Financing Gap

Benefits of Angel Finance

- In addition to the money provided, angel investors play a key role in providing ***strategic*** and ***operational expertise*** for new ventures as well as ***social capital***.
- Angel investors traditionally invest ***locally*** (within a few hours' drive) and in a ***wider range of sectors*** than venture capitalists.
  - This means there is broader investment coverage than for venture capital investment.
- Companies backed by angel investments have been important contributors to jobs and economic growth.
  - In the US, estimates suggest that approximately 250 000 new jobs were created in 2009 by firms supported by angel investment, representing 5% of new jobs in the United States. (Sohl 2010).
  - Young firms in the US with angel financing have an increased probability of survival and improved performance and growth of 30 to 50% on average (Kerr, Lerner and Schoar, 2010).

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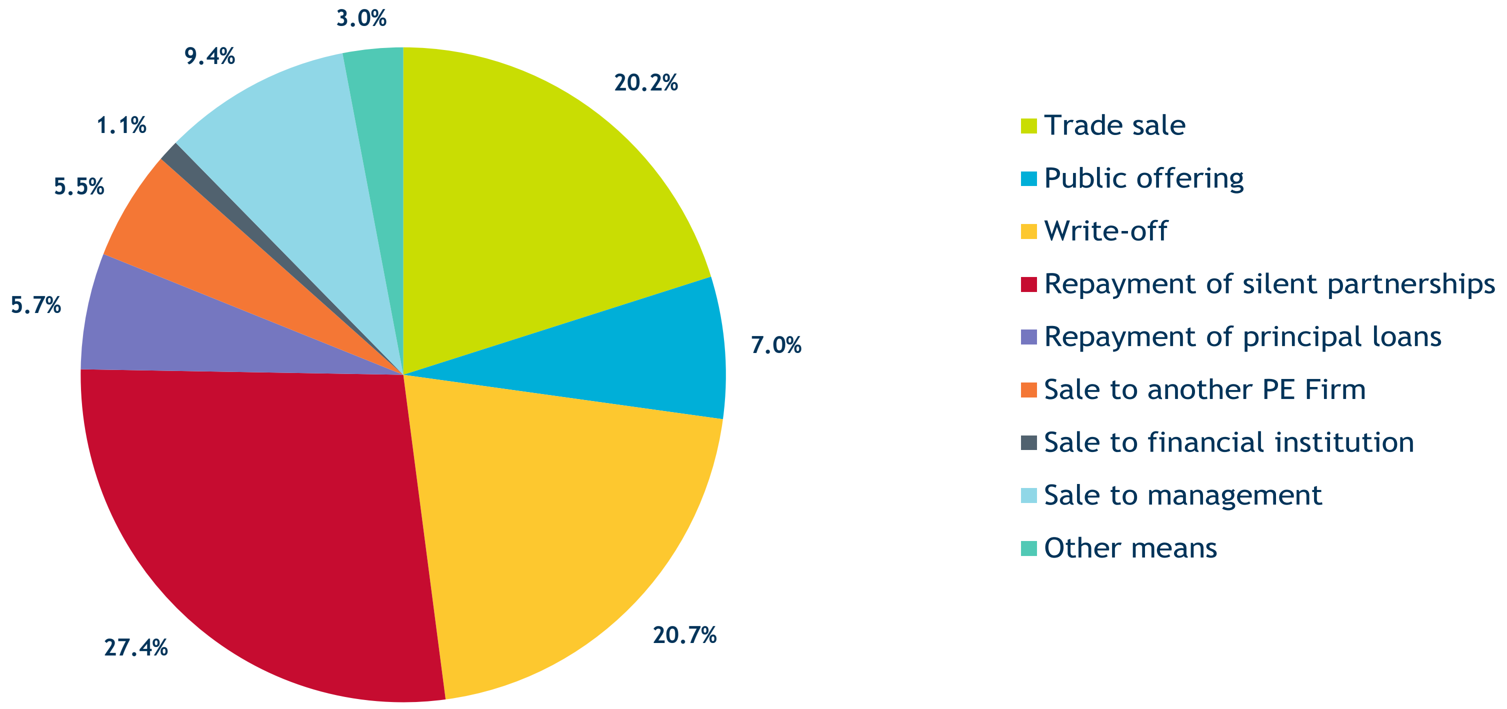
Differences between Angels and VCs

Characteristics	Angel Investors	Venture Capitalists
Background	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Range of seed, early stage and later stage but increasingly later stage
Investment instruments	Common shares	Preferred shares
Deal Flow	Through social networks and/or angel groups/networks.	Through social networks as well as proactive outreach
Due Diligence	Conducted by angel investors based on their own experience. (more cost efficient)	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.) (more costly)
Geographic proximity of investments	Most investments are local (within a few hours drive).	Invest nationally and increasingly internationally with local partners
Post investment role	Active, hands-on	Board seat, strategic
Return on Investment	Important but not the main reason for angel investing	Critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Source: OECD, adapted from EBAN 2006 referencing Wong 2002 and Ibrahim 2010

Exit Markets Remain a Challenge for Equity Investments

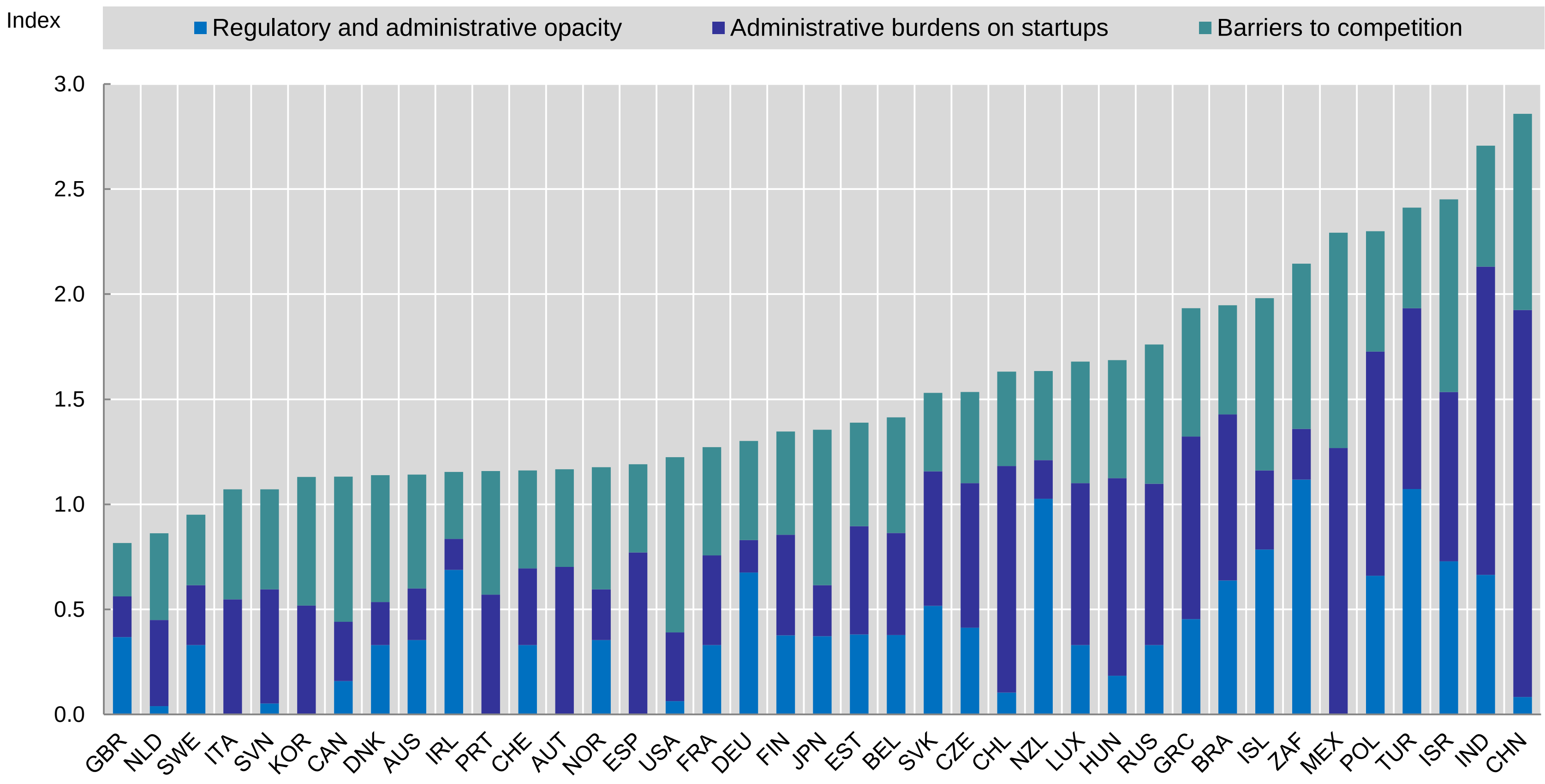
European Venture Capital Exits in 2011
(Percentage of number of companies)



Source: EVCA/PEREP Analytics 2012.

Regulatory and Administrative Barriers

(2008)



Note: Scale from 0 to 6 from least to most restrictive.

Source: OECD, Product Market Regulation Database, May 2011.

Potential Regulatory Constraints

- Restrictions on institutional investors investing in alternative assets
  - Particularly banks, pension funds and insurance companies in some countries.
- Legal structures
  - Lack of appropriate structures, such as limited liability partnerships and tax flow through vehicles.
- Securities legislation limiting private investment
  - Rules for "qualified" investors, solicitation and advertising of investment opportunities.
  - International accounting and financing directives.
- Cross-border investments
  - Restrictions on some public-private and public VC funds.
  - Programmes in place to attract VCs and/or angel investors.

General framework conditions as well as bankruptcy law, employment legislation and financial market development are critical.

Entrepreneurial Ecosystem

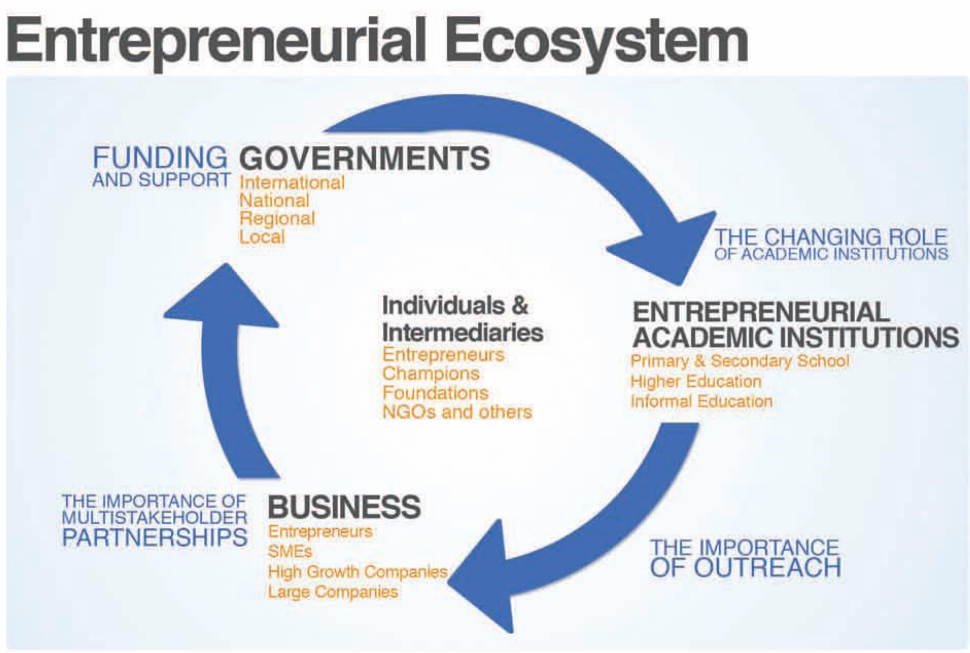
(Demand Side)

Human Capital Development:

- Entrepreneur Training
- Investor Training
  - Only a few OECD countries have programmes focused on training investors (institutional, VC or angels).

Social Capital Development:

- Incubator
- Accelerator
- Angel Networks (BANs)
- Matchmaking services



Data and Evaluation

- Increasing support for financing instruments over the past 5 years, however, limited evaluation of these policies to date.
  - Fewer evaluations of tax and equity instruments as compared to debt instruments (although many of these programmes are newer).
  - Many evaluations of risk capital policies in OECD countries to date seem to have been more qualitative than quantitative.
  - The majority of evaluations have been conducted by outside experts/academics.
- Further learning and sharing of information is needed to determine what is working and what is not.
- Better data collection is needed to monitor results and adjust programmes accordingly.

Conclusions

- Support for supply-side interventions is growing in OECD countries
  - Yet evidence of the impact of these programmes is not conclusive and therefore other countries should be careful about "copying" policies.
  - Equity financing is only appropriate for innovative high growth young firms but the appropriate exits markets (IPO and/or M&A) are needed as well.
- The full policy mix should be taken into account
  - Framework conditions and potential regulatory barriers need to be assessed, particularly in developing countries, as these are often the main challenges.
  - More attention should be paid to demand side measures.
- Policy should focus on leveraging (not replacing) private funding.
  - Creating incentives for institutional investors, funds, firms and individuals to invest in high growth firms.
  - Ensuring that investment decisions are made by experienced professional investors.
- Design, structure and implementation of policies can make the difference between success and failure
  - Data, evaluation and experience sharing is important.

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OECD Publication on Angel Investment

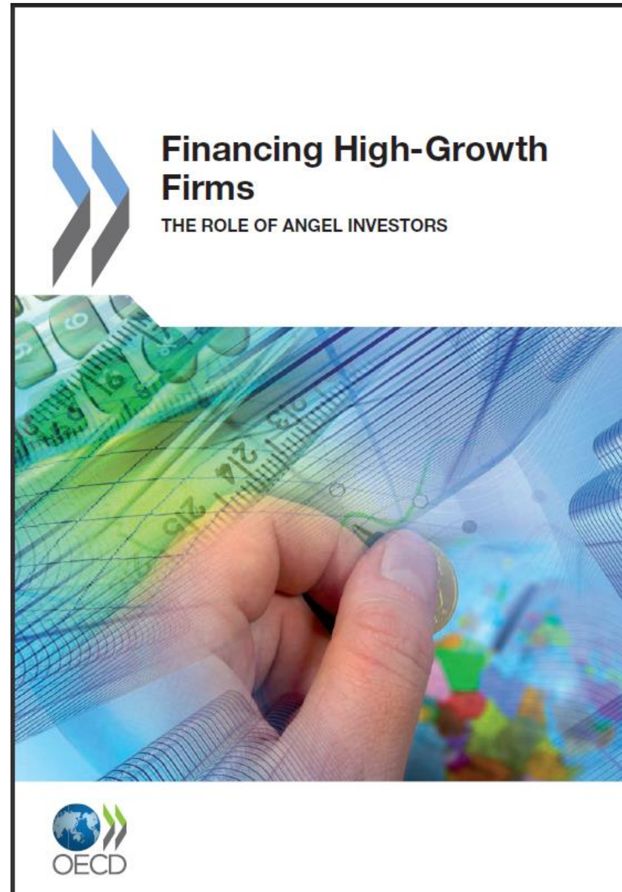
www.oecd.org/sti/angelinvestors

Chapter 1: Overview of financing for seed and early-stage companies

Chapter 2: Angel investment: Definitions, data and processes

Chapter 3: Trends and developments in the angel market around the world

Chapter 4: The role of policy in facilitating angel investment



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