Options for delivering risk capital to innovative enterprises in Belarus

Concluding Webinar

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Why some demands for financing are denied

Negative cash flows, untried business models, and high uncertainty explain the reluctance of traditional providers of finance to invest in the early stages of innovation

The various options for facilitating equity-type investments in innovative enterprises are only a partial solution to the unmet demand for funding by new or high-risk ventures

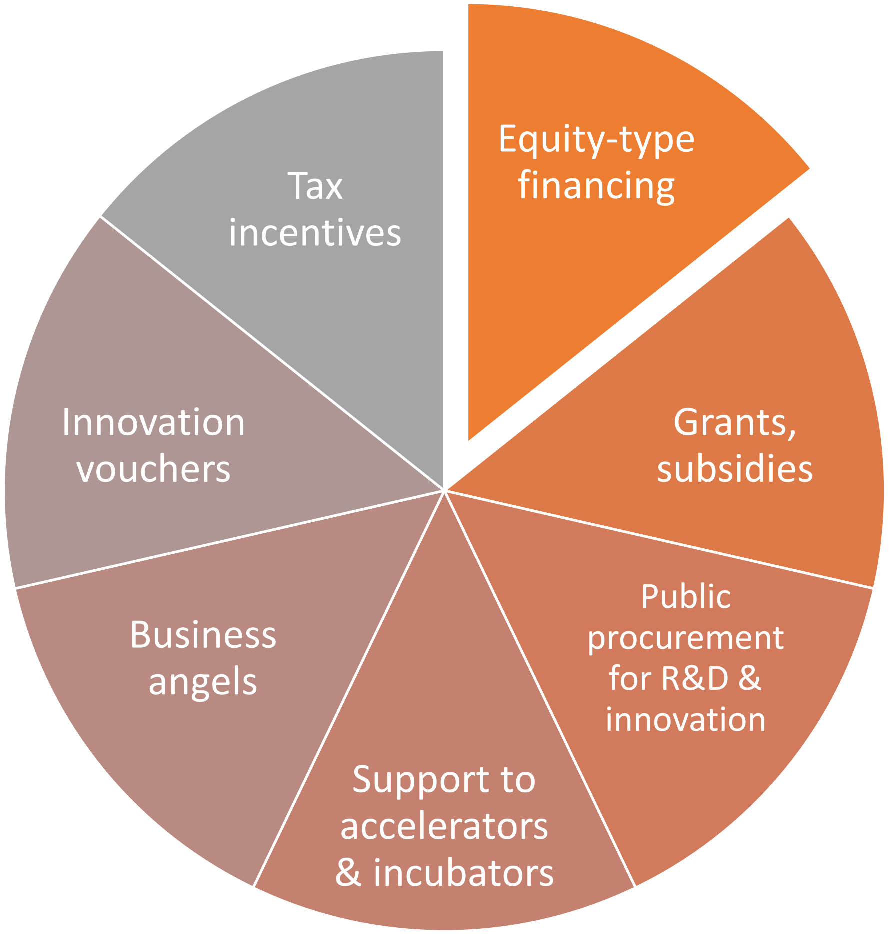
Alongside financial assistance measures, broader efforts to expand general access to finance for smaller enterprises also address infrastructure issues such as improving the business environment for SMEs, building SME capacities, and promoting access to markets

Funding Arrangements for Innovative SMEs

STAGE OF FIRM'S LIFE CYCLE	SOURCES OF RISK CAPITAL	SUPPORTING FACTORS
Seed	Personal Assets Family & Friends Individual Investors Academic & Professional Colleagues Government & University Grants Endowments and Foundations Seed Funds	**Supportive environment for Entrepreneurship** **Business/Government/Research Links** **Government & University Support for Applied Research**
Start-Up	Family & Friends Individual Investors Academic & Professional Colleagues Government & University Grants Business Angels Venture Capital Endowments and Foundations	**Robust Legal System** **Enforceability of Contracts** **Efficient Bankruptcy Regime** **Support Facilities** **Science Parks/Incubators** **Favorable Tax Environment** **Business Angel Networks**
Expansion	Business Angels Venture Capital/Private Equity/Mezzanine Finance Pension Funds Endowments and Foundations Corporate Venturing Government Foreign Venture Capital	**Institutional Savings** **Sufficient Volume** **Flexible Regulation** **Legal Framework** **Tax Transparency**
Exit	**IPO** **Institutional Investors** **Retail Investors** **Trade Sale** **Strategic Investors (M&A)** **Private Equity**	**"Growth" Exchanges/Second Tier** **Environment for M&As**

Source: OECD

Integrated options for financing innovative projects



Importance of fund-level details: all depends on the objectives

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Basic fund types are generalizable, with contract terms & payoff structures matched to the risk profiles and financial market structures of target firms and to the objectives of investors

There are many idiosyncrasies at the country level resulting in a diversity of underlying fund structures

Many programs are designed to encourage additional equity finance for new and young ventures with perceived high potential

Participation of private investors raises the available resources, but comes at a cost

To encourage the participation of private investors some funds are structured to enhance the expected returns of private partners, e.g. by altering the distribution of profits, changing the timing of investment draw-downs, providing downside protection such as guarantees for loss invested capital, or capping the returns of the public investor

A high-level comparison of "generic" fund models

Criteria	Equity Carry (Portage) Model	Co-Investment models		Fund of Funds Model
		Privately managed government-backed venture capital fund	*Co-investment in a privately managed venture capital fund*	
Use of preference shares (e.g. convertible preferred equity	no	yes	yes	maybe
Link to Informal capital market (accelerators, incubators, business angel networks, science & technology parks)	yes	yes	yes	yes
Reliance on the existence of several local private venture-capital funds	no	no	no	Yes
Use of partnership agreements	no	no	yes	Maybe
Selection of investee companies	Government entity	Private fund manager	Private fund manager	Government entity or private fund manager (If as limited partner)

Criteria	Equity Carry (Portage) Model	Co-investment models		Fund of Funds Model
		Privately managed government-backed venture capital fund	*Co-investment in a privately managed venture capital fund*	
Potential for follow-on financing during life cycle of agreement	no	yes	yes	yes
Nature of exit	Resale of common shares	IPO, trade sale, repurchase by entrepreneur, M&A	IPO, trade sale, repurchase by entrepreneur, M&A	IPO, trade sale, repurchase by entrepreneur, M&A
Returns contingent on exit	No	Yes	Yes	Yes
Potential conflicts over control	No	Yes	Yes	No (yes, if as limited partner)

Direct public equity financing versus guarantee provision

In all three models, direct equity financing by a public entity can be substituted with the provision of guarantees to the private equity investors.

State backed guarantees will allow private equity investors to borrow from banks or other financial institutions at favorable conditions.

Guarantee contracts generally contain provisions similar to those found in the VC or portage partnership agreements.

In this case the public entity will negotiate the conditions for calling the guarantees with the private equity investors.

For the public authorities guarantees are attractive as they do not involve the immediate allocation of states funds.

For the private VC investors they are attractive only if they provide coverage against risks equal to direct equity investment and allow private investors long term borrowing from banks and financial institutions at attractive rates.

Final considerations

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Each of the three model has its own advantages and counter indications.

In terms of legal and operational complexity, the portage model is the simplest and it has been adopted by a number of countries with relatively underdeveloped capital markets (i.e. Tunisia). But it has also limited spin-off effects, in terms of promoting the development of a domestic VC sector and enhancing competition among potential VC investors;

The other two models require the presence of already active business angels or VC investors, in addition to a more advanced legal and operation environment.

They also require a high level of confidence by private VC investors in the country legal system, rule of law conditions and tax and public policy transparency.

They are the mainstream models, adopted in the early stages of the VC industry development, by the US and later by Israel.

Final considerations

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A further variation sees an international financial institution (EBRD or IFC), taking a leading role, aggregating public and private investors (and sometimes also other IFIs), either adopting in a fund of funds or in the hybrid/specialized fund model.

The European Investment Fund has been instrumental in the development of the VC industry in several new EU member states and Turkey.

In the case of Western Balkans Enterprise development and Innovation Fund (WB EDIF) several multilateral (EIB, EIF, EBRD) and the EC have joint forces to set up a regional fund providing both equity investment and loan guarantees to innovative and fast-growing enterprises.

The advantages of collaborating with of an international financial institution:

- provision of expertise

- long-term financing

- associated technical assistance.

Final considerations

Belarus is at a crucial intermediate stage. It has an emerging, active and professional business angels and VC sector, a semi-developed legal framework, but lack of a liquid and diversified capital market and it is particularly weak in terms of public policy transparency and trust in the rule of law.

The next steps involve a wide process of consultations with all the private and public entities that may play a role in finding solutions to long term innovate companies financing. Several attempts to launch this process are already under way, including the UNECE supported Task Force

This should lead to the identification of a realistic option among those listed which has a broad public and private support. The government should then identify the leading institution in charge of the project development and launch an in-depth feasibility study, looking at the economic financial, legal and operational implications, before moving ahead with the allocations of financial resources.

Thank you

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