Promoting support policies for innovative, high-growth enterprises (IHGEs) in Eastern Europe and South Caucasus (EESC)

Training Session 3

Financing IHGEs – enabling private sector investments

22 March 2021

Agenda for the session

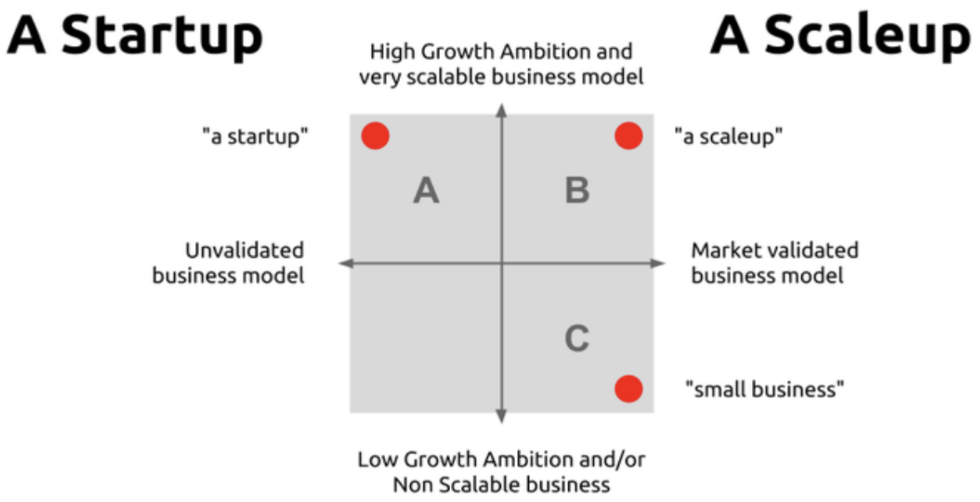
09:30-10:00	Mobilising the right mix of finances for IHGEs – ensuring access to equity capital as a driver of growth Alasdair Reid, Policy Director, European Future Innovation System Centre, Belgium
10:00-10:45	Case study session Participants will be divided into two breakout groups - moderated by Alasdair Reid and Lyudmyla Tautiyeva.
10:45- 11:00	Virtual coffee break
11:00- 11:15	Report back from the case studies
11:15- 12:00	Practitioner insight: Lessons from financing innovative high growth firms in Eastern Europe and the Balkans Marco Giuliani, Mandate Manager, European Investment Fund Tatjana Zabasu Mikuž, Managing Partner, South Central Ventures
12:00-12:25	Wrap-up brainstorming - “How, Now, Wow”. What should be done to develop an investor ecosystem for IHGE in the EESC ?
12:25-12:30	Conclusions Anders Jönsson, Chief, Innovative Policies Development Section, UNECE

Reminder: What are innovative high-growth enterprises (IHGEs)?

IHGEs are firms that meet three criteria:

- have at least 10 employees in the beginning of their growth,
- have average annualized growth in number of employees and/or turnover greater than 10% per annum over a three-year period,
- carry out innovation activities in a broad sense, i.e. introducing new or significantly improved products, services, marketing and organizational methods to the local market or industry.

They are not necessarily start-ups, nor only found in ‘high-tech sectors’.



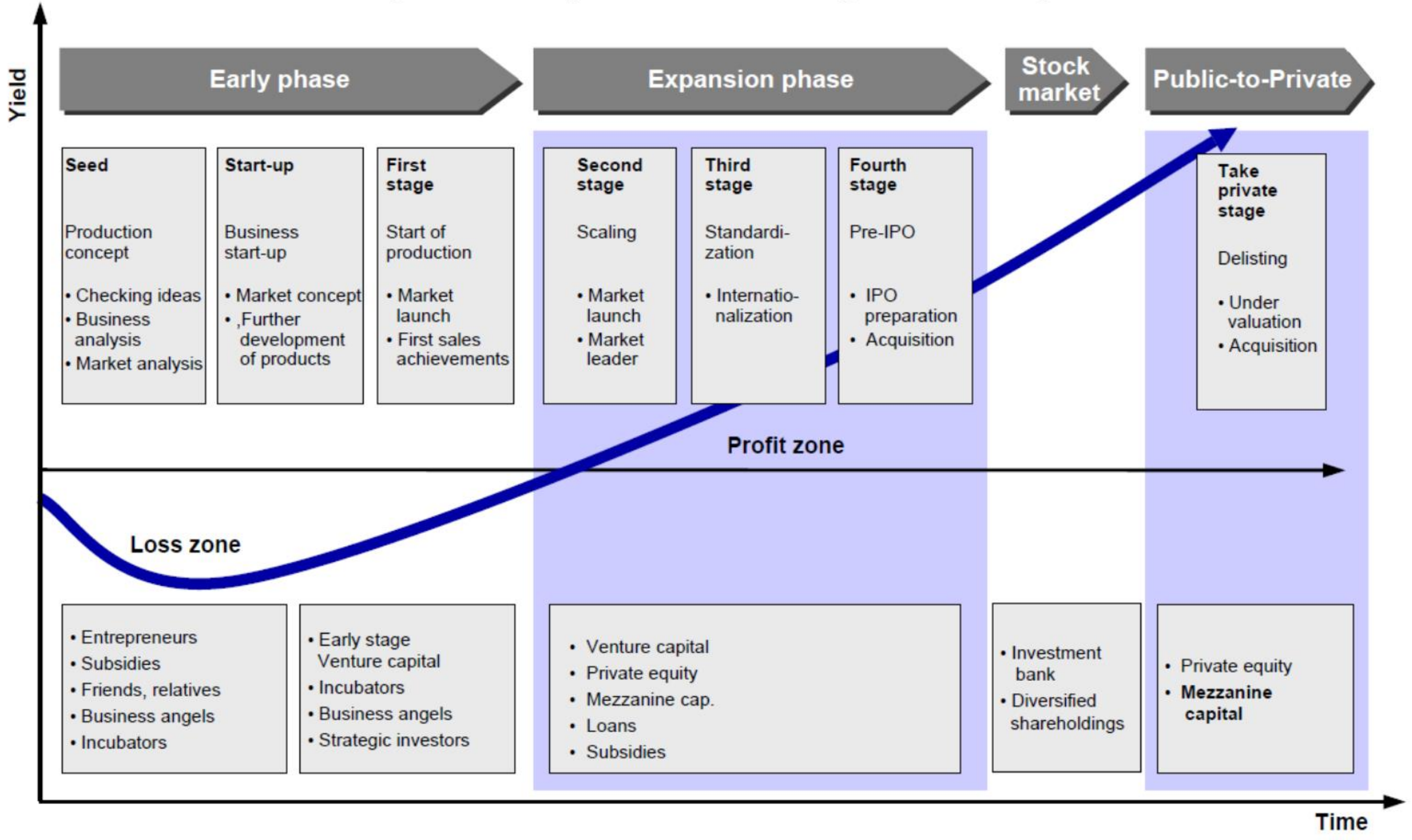
What are the challenges for IHGEs in raising finance in the EESC ?

- Public sector support (grants for innovation, support for equity investments etc.) still nascent in EESC
  - focus on support for start-ups (notably IT/digital) but lack of policy targeting growth (scale-up) stage of innovative firms;
  - 'Accelerators' (providing start-up/scale-up advice and access to equity) present in EESC.
- Legal and regulatory environment for investments and investors remain under-developed (to varying degrees) in the six countries
- Investment in scale up to €100k can be raised locally but difficult to raise funding from national investors above this level
- IHGEs seeking greater levels of investment tend to incorporate abroad - for good reasons including closeness to markets and investors.
- Perceived risk (geopolitical, etc.), limited deal flow and lack exit (IPO market) routes limit interest of investors in region.

Source: https://www.eif.org/news_centre/research/the-vc-factor.pdf

Finance for IHGEs : the right instrument at the right time

Figure 2. Life-cycle of a firm and stages of financing



Source: Natusch (2003);OECD (2013d).

A range of financial instruments are possible (but not always available)

- Direct financial support : grants, innovation vouchers, etc.
- Tax credits (indirect financial support): for R&D, digitalisation, etc.
- Debt financing : lending to SMEs including SME loan guarantees
- Demand side – Innovative Public Procurement
- Equity finance with public policy instruments for private investors

Debt financing – tailored to IHGEs needs

Debt finance: essentially involves borrowing money that has to be paid back, along with the interest.

- Different forms: Loans and overdrafts are offered by banks and other lending institutions, as well as peer-to-peer business or startup loans.
- Overdrafts tend to be well-suited for financing working capital and to meet short-term requirements, whereas loans are more often used to finance larger and longer-term purchases.

To encourage financial institutions to to invest in riskier, more innovative firms, governments can :

- provide targeted loan guarantee facilities to commercial banks – e.g. focused on specific types of firms (start-up loans) or different stages of growth (expansion stage).
- Provide convertible and subordinated loan type instruments

KredEX (Estonia) example two main instruments:

- Start-up loan of up to EUR 100,000 – helps companies with insufficient collateral or operating history
- Capital loan – a subordinated loan of up to €2m – for companies that have proven business model

Direct financial support – grants to IHGEs

Non-repayable nature of these funds can be attractive for IHGEs, but to ensure additionality requires strict eligibility criteria.

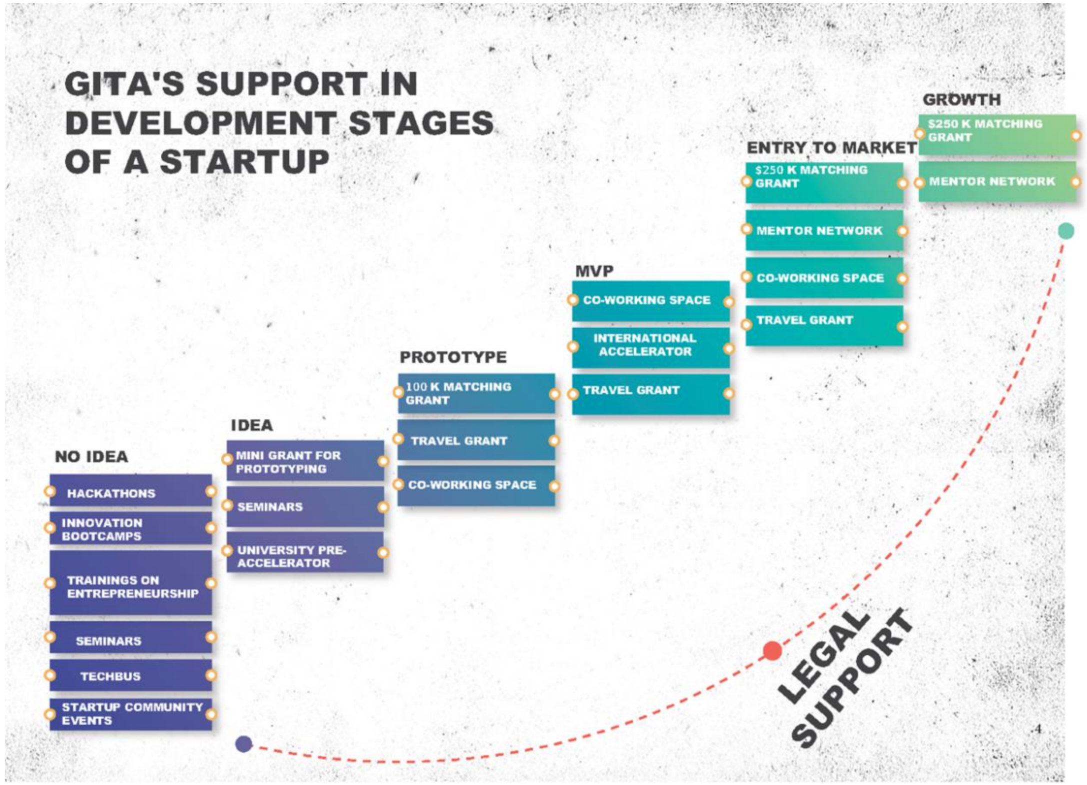
Finding and applying for grants can be a time-consuming and competitive process.

Main instruments:

- Innovation vouchers (small grants enabling to test ideas before further development)
- Feasibility/proof of concept grants – to take idea to higher 'technology readiness level'
- R&D / product development grants – to develop prototypes and test with users, etc.

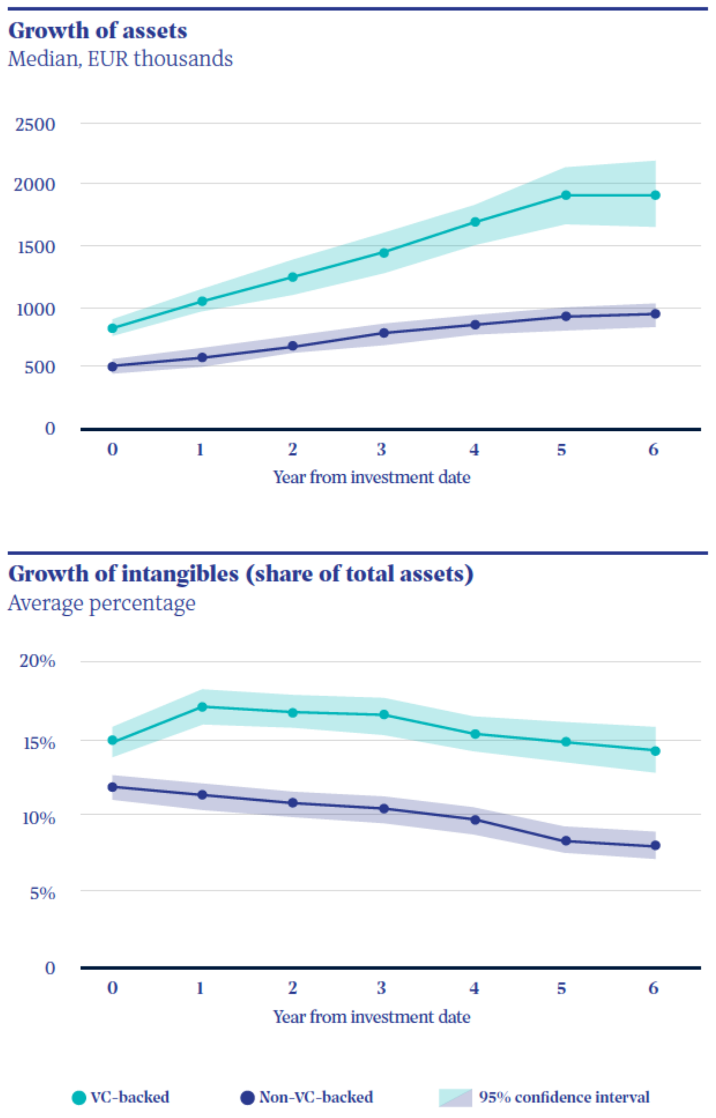
Share of public funding should decrease as idea moves 'closer to market'.

Apart from grants, governments may offer other subsidies for IHGEs, such as tax breaks.



Why is equity finance important ?

- Firms with equity finance tend to outperform those reliant on debt and own resources.
- IHGE require access to external equity capital to support their product development, operations and expansion phases into international markets;
- Equity finance matches the risk profile of an IHGE with potential payoff. By receiving equity stakes in exchange for their capital, investors have claims on the future value of the enterprise, sharing upside potential but also downfalls.
- For IHGEs seeking to scale, equity finance should provide:
  - Deep pockets: ability to support additional rounds of investments
  - Smart money: industry and domain expertise
  - Networks : providing access to markets and other investors/funders
  - Patient capital : supports entrepreneurs to bring disruptive innovation in products, processes and business models to market.



Source: https://www.eif.org/news_centre/research/the-vc-factor.pdf

Main forms of equity finance for IHGEs

Equity crowdfunding

- Emerging form of finance – a step beyond ‘family, friends and fools’
- Pre-seed/start-up but also market launch/early scaling stages
- Requires robust regulatory framework

Angel investors

- High net worth individuals who invest own time and money. Angel investment is always a minority investment (usually 10–30%), and is directed at the pre-seed, early or second growth stage.
- Business angels often work in groups or syndicates to pool investments and help create a balanced portfolio of investment.

Venture capital

- Mainly make later stage minority or expansion investments
- Potential for venture funding heavily dependent on sufficient deal flow, investment readiness, institutional (e.g. pension) funds & regulatory framework that favour equity investment

Public-private mechanisms for leveraging equity capital

Three main options for public-private mechanisms to innovative and risky projects:

- The "co-investment" model with two types of governmental support:
  - a privately managed government-backed venture capital fund that invests on a non-exclusive basis in innovative companies; and
  - public investment as a co-limited partner in a privately managed venture capital fund;
- the "equity carry" model (portage)- a contractual arrangement where government acquires equity shares from private investors for a fixed period and sells them back at a pre-specified price in the future; and
- the "fund-of-funds" model requiring the establishment of a public fund that takes minority equity stakes into existing or new privately managed venture capital funds

Pros and cons of public-private equity instruments

Equity portage

- Simplest and effective in countries with underdeveloped capital markets
- Limited spillover effects on private investor/VC sector

Co-investment fund

- Limit risks of market distortion and have proven to be effective in a range of countries – notably for early stage
- Require existing presence of active investors

Fund of funds

- Widely used to leverage venture capital investments without direct public sector investment in firms.
- Minimal deal flow required – often multi-country (Baltic, etc.)

Public policy tool kit for improving investment ecosystems

Supply - generating more investors	Demand - quality deal flow	Market Impact and sustainability
Remove tax system obstacles and review tax incentives for investors	Investment readiness (incl. regional training and support)	Support for sustainable and professional BANs
Co-investment funds, funds of funds	Improve financial literacy via educational curricula and training	Data collection on investment (investment platforms, etc)
Investor readiness training sessions	Entrepreneurial mind-set development (incl. links with local businesses)	National business angel and VC forums
Media campaigns – role model examples of investors and successful investments	Incubators and other facilitators to educate and prepare entrepreneurs	Light regulation for early-stage investment market

Key principles for financing innovative high-growth enterprises

1. Get the rules of the game right - ensure transparency of legislative and regulatory frameworks, and balanced investor protection.
2. Support the development of a pipeline of investable firms (high-growth programmes - portfolio approach).
3. Ensure IHGEs have access to a ‘blend’ of financing (grants, loans, equity) that support innovation and scaling of operations
4. Support the development of investor communities through education, promotion and targeted support for angel networks, accelerators, etc.
5. Avoid direct investments by public sector agencies in firms – favour support through co-investment – so that public funding matches rather than displaces angel or VC investors

Case study session – finance for IHGEs

During this session, the participants will be split into groups supported by a moderator and will work in two steps. Each group will be assigned one of the two IHGE business cases.

Step 1 (25 minutes) : design a package of funding to help grow the company, with a focus on equity finance: equity crowdfunding, angel investors, venture capital (co-investment, fund of funds).

Step 2 (20 minutes) : examine what policy measures could be taken to enhance and reinforce the investor ecosystem in the EESC countries, taking into account the conclusions of step 1.

Outcome: three priority actions (recommendations) for policy in the EESC.

Case 1 – an existing (10+ years since establishment) food manufacturing firm - registered HQ in an EESC country.
The company has +/-100 employees and has in-house a small lab for testing and quality control staffed by three qualified food technicians. The company has existing export sales (30% of turnover) to the EESC region, Romania, Bulgaria, Greece, Iran, etc. .
Trigger point: change of management
Ambition : first mover in new 'plant based proteins' products in EESC
Challenge: to secure investment and expertise for new product development and export markets

Case 2 : IT start-up launched by two young founders in 2017 focused on services based on Internet of Things (IoT) devices and data.
The +/-20 strong staff (including the R&D team) are based in one of the EESC capital cities. However, the company is incorporated in Delaware and one of the founders is now located in Boston (USA). The company has received several rounds of seed-stage investment (up to €1.5m) from a mix of local and US equity investors.
Trigger point: Internet of Behaviour global trend
Ambition : become a global player in IoB for health sector
Challenge: Raise Series A investment and secure entry to market subject to strict data protection legislation

Brainstorming session – How, Now, Wow

The aim of this session is to identify priority actions that should be taken to enable EESC countries business support ecosystem to provide more targeted advice to IHGEs.

Now – what can be done in the short term, with minimal effort, in my country, to improve access to finance for IHGEs.

Wow – ideas sparked by the training that are new or innovative to my country which would really change the investment climate for IHGEs.

How – actions that require more time and investment to prepare but that we need to do in a medium-term perspective to develop the investment Ecosystem