

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

José Palacín

**Economic Cooperation and Integration
Division**

**United Nations Economic Commission for
Europe**

Minsk, Republic of Belarus, 12-13 July 2012

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 6

Design, Implementation, and Evaluation of Early-Stage Financing Policies

Module objectives

- **General framework conditions for innovation finance**
- **Major templates for policy intervention**
- **Comprehensiveness and sustainability**
- **Evaluation of policy initiatives**

Innovation policies

Target: increasing the availability of private sector financing to innovative SMEs

- Development of specialised financial intermediaries – Venture capital industry
- Extensive programmes of public support

Awareness: The financing challenge needs to be addressed for effective commercialization of ideas and to overcome the “European paradox”

Why public support?

- **Innovation is underprovided by markets**
- **Market failures due to information asymmetries**
- **Increasing returns and infant industry arguments**
- **Empirical test: everybody does it!**

Framework conditions



Innovative enterprises as plants

- **Dispersion of seeds on fertile soil**
 - As many seeds and directions as possible
 - Seed intermediaries help with sprouting
- **Once sprouted, need to emerge above ground**
 - Start-up intermediaries help with initial hurdles
 - Product development and initial market testing
- **Once above ground, photosynthesis kicks in**
 - Early-growth intermediaries fire up the process
 - Deploy financial, human, and social capital

Four critical interfaces

- **Intermediaries need capital (fundraising)**
- **Capital needs to be deployed (investing)**
- **Enterprises need to succeed (value adding)**
- **Investments need to be liquidated and capital re-deployed (exiting)**

Generic templates for intervention

- **Direct funding**
- **Indirect funding**
- **Credit enhancement**
- **Tax incentives**
- **Technical, infrastructure, or knowledge support**

Direct funding

- **Feasibility grants**
 - Target potential entrepreneurs
 - Aim to identify promising ideas
- **Public VC funds**
 - Target potential or nascent entrepreneurs
 - Feasibility study, start-up process

Indirect funding

- **Business development grants, loans, equity**
 - **Provided to incubators, technology transfer offices, micro-finance institutions**
 - **Investment functions are outsourced**
- **Fund-of-fund programmes**
 - **Target (private) VC funds**
 - **Provide legitimacy, leverage, enhanced returns**

Credit enhancements

- **Debt guarantees**
 - Offered to financial or micro-finance institutions
 - Reduces risk perceptions on innovative enterprises
- **Equity guarantees**
 - Offered to seed or early-stage private investors
 - Improves economic viability and investment scale

Tax incentives

- **Provided to individual, corporate or institutional investors**
- **Major forms**
 - **Tax rebates for investments in certain companies**
 - **Tax deduction for losses**
 - **Exemption or deferral of capital gains**

Technical and knowledge support

- **Information dissemination**

- To potential entrepreneurs and investors
- Close information gaps and fragmentation

- **Training and knowledge dissemination**

- To potential entrepreneurs and investors
- Increases the rigor in the investment cycle

- **Business services**

- Feasibility studies, business planning
- Professionalization of potential entrepreneurs

The issue of comprehensiveness

- **Synergies and complementarities among programmes**

- **All four interfaces need to work**
- **High-level coordination of programmes**
- **Ad hoc vs. coordinated approaches**

- **Learning mechanisms in policy making**

- **Learn for others' experiences**
- **Careful understanding of goals and results**
- **Proper and effective measurement and evaluation**

The issue of sustainability

- **Can private investors operate without public support and function on their own?**
- **Economic viability of small seed funds**
 - **Inability to provide follow-on funding**
 - **Larger size discourages small investments**
 - **Balance between practicality and feasibility**
- **Fund-of-fund programmes need to engage private and institutional investors**
- **Regional focus vs. supply/demand for capital**

Programme evaluation

- **Key questions**
 - **Have the immediate objectives been achieved?**
 - **What has the programme's impact been?**
- **Careful design to balance effectiveness and efficiency**
- **Key design and implementation issues**
 - **Displacement of private funding**
 - **Targeting the right recipients**
 - **Measuring success**

Displacement of private funding

- **Would financing be possible without the public programme?**
 - If yes, programme is redundant and inefficient
 - But getting the answer is not easy
- **Does the programme attract enterprises of marginal or poor quality?**
 - Would a private investor invest in these?
 - Expertise and selection criteria of decision makers

Targeting the right recipients

- **Is this an “innovative enterprise”?**
 - **Carefully derived and tested operational definitions**
 - **“Novelty” can apply to a wide range of domains – product, market, process, location**
- **What is a seed-stage enterprise?**
- **What is an early-stage enterprise?**
 - **Age**
 - **Number of employees**
 - **Assets and revenues**

Measuring success

- **Success is an elusive concept**

- **Survival, growth, profitability, social impact, etc.**
- **Common metrics are necessary for comparisons**
- **But focus on single metrics can ignore other, less tangible aspects of the enterprise**

- **“Pressure” to show tangible results**

- **Could lead to too much focus on short-term metrics**
- **But exclusive long-term focus begs the delicate question of whether further funding is necessary**
- **Need for set milestones and staged funding**

Good practices

- **Different national context, variety of targets**
- **Comprehensiveness of interventions – addressing both supply and demand factors**
- **Coordinated programmes that build on previous achievements**
- **Mapping the provision of finance to identify bottlenecks**
- **Strengthen links between players**

Thank you!

Jose.Palacin@unece.org

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