Venture capital funds in development institutions:

An opportunity for Belarus?

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1. Introduction and key points

- Belarus has considerable potential in the ‘knowledge economy’. But a large number entrepreneurs/start-ups with promising concepts are constrained in debt and equity financing
- Some of these financing constraints are justified by poor framework conditions, in particular enforcement and corporate governance standards, which should be reformed
- Other constraints represent failures in the financial market that could potentially be overcome through public sector VC activity
- It is essential that any public scheme operates at arms-length, through professional management, and based on transparent investment criteria. Ideally, there should be risk sharing with the private sector

2. The business model of venture capital

- Venture capital supports the pre-launch, launch and early stage development phases of a business (OECD)
- The key contributions are seed capital for R&D or product development, and growth capital for the early growth phase of a start-up enterprise
- Innovative technologies take many years to develop and have unpredictable returns. Start ups do not have sufficient collateral or a business record. Bank credit is therefore not suitable
- VC funds will be closely involved in governance and operational structures of the investee
- Business angels provide smaller financing tranches than VC funds. These are high net worth individuals who directly invest part of their assets in start-up enterprises. They bring specific industry knowledge and contacts and will typically be involved through a non-executive board position

The economic potential of venture capital

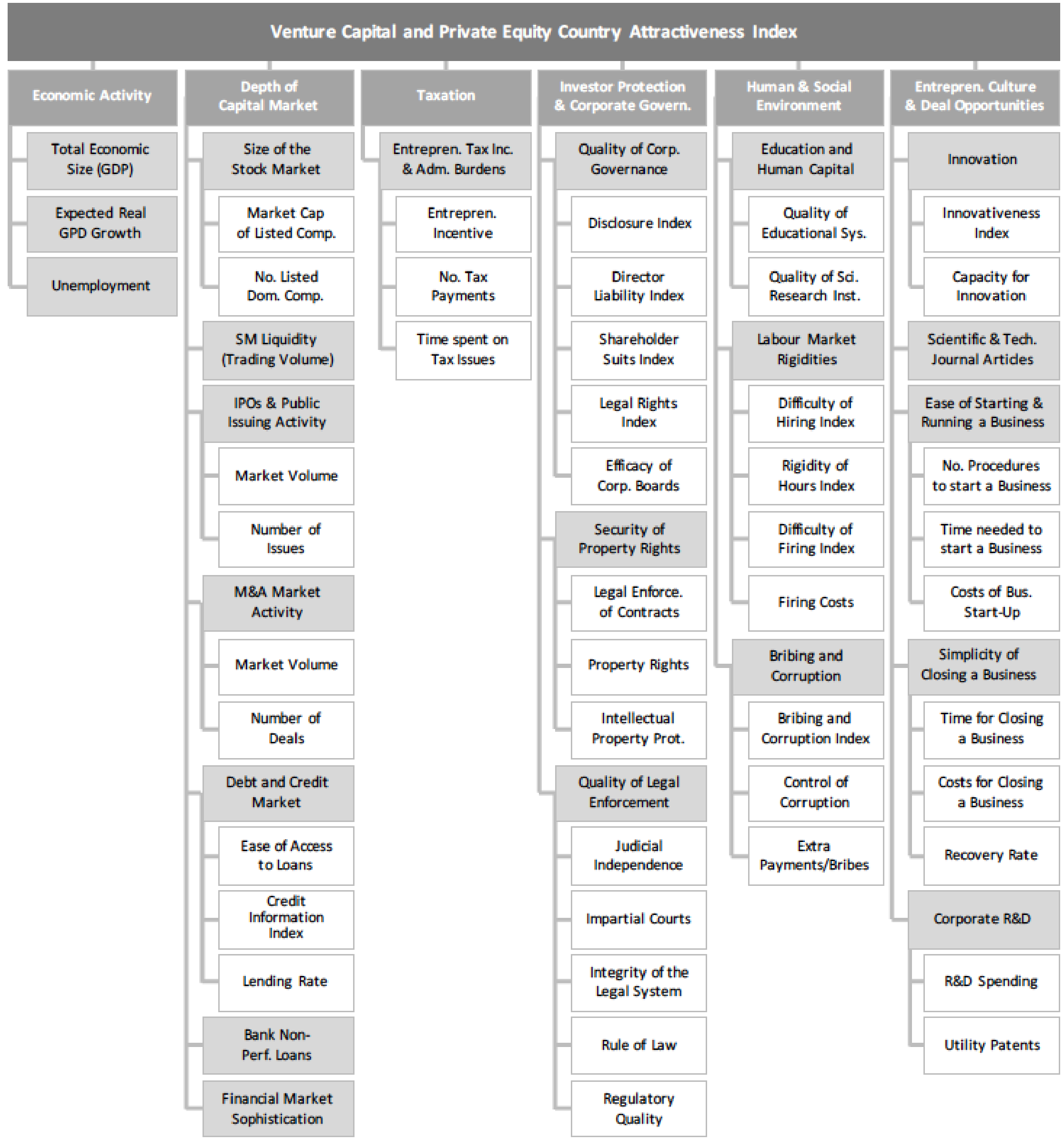
- VC will spur innovation by overcoming financing constraints of young companies. As a highly risky sector VC requires private sector expertise and risk sharing
- Empirical literature on private equity/VC involvement (e.g. EBRD, 2015)
  - PE funds help investee firms gain access to credit, and will raise its capital spending
  - Monitoring, governance and operational restructuring raises innovation and productivity within the firm
- There is an extensive empirical literature on the impact of private equity on the wider economy, also confirmed for the VC segment:
  - Positive impact on corporate revenue growth, employment and labour productivity, albeit only after about three years
  - Capital expenditures more than make up for any asset reductions implemented in the course of operational restructuring

3. Regulatory conditions and taxation

- VC regulation is part of a broader environment that will need to be receptive for risk capital. Key aspects are:
  - Investor protection, corporate transparency and corporate governance
  - Transparent and predictable taxation that is efficiently administered
  - Contract enforcement and protection of intellectual property rights
  - Liquid local capital markets as an ultimate exit option
- The wider innovation framework and economic growth are also important:
  - Local innovative activity
  - Government R&D spending and start-up programmes will attract VC

VC and PE attractiveness index (IESE Business School) assesses local demand and expectation of efficient deal making based on 6 indicators:

1. Economic activity
2. Depth of capital market
3. Taxation
4. Investor protection and corporate governance
5. Human and social environment
6. Entrepreneurial culture and ‘deal opportunities’.



Framework conditions in the region

Country	Overall rank	Economic activity	Depth of capital market	Taxation	Investor protection and corporate gover-nance	Human and social enviro-ment	Enterpre-neurial culture and deal oppor-tunities
	(out of 125)	Score (US=100)					
Belarus	**97**	**74**	**11**	**99**	**46**	**51**	**53**
Czech Republic	33	85	48	102	71	73	73
Turkey	35	94	72	107	59	43	56
Poland	26	89	76	108	63	61	67
Ukraine	83	72	31	100	49	33	52

Source: 2018 VC and PE country attractiveness index

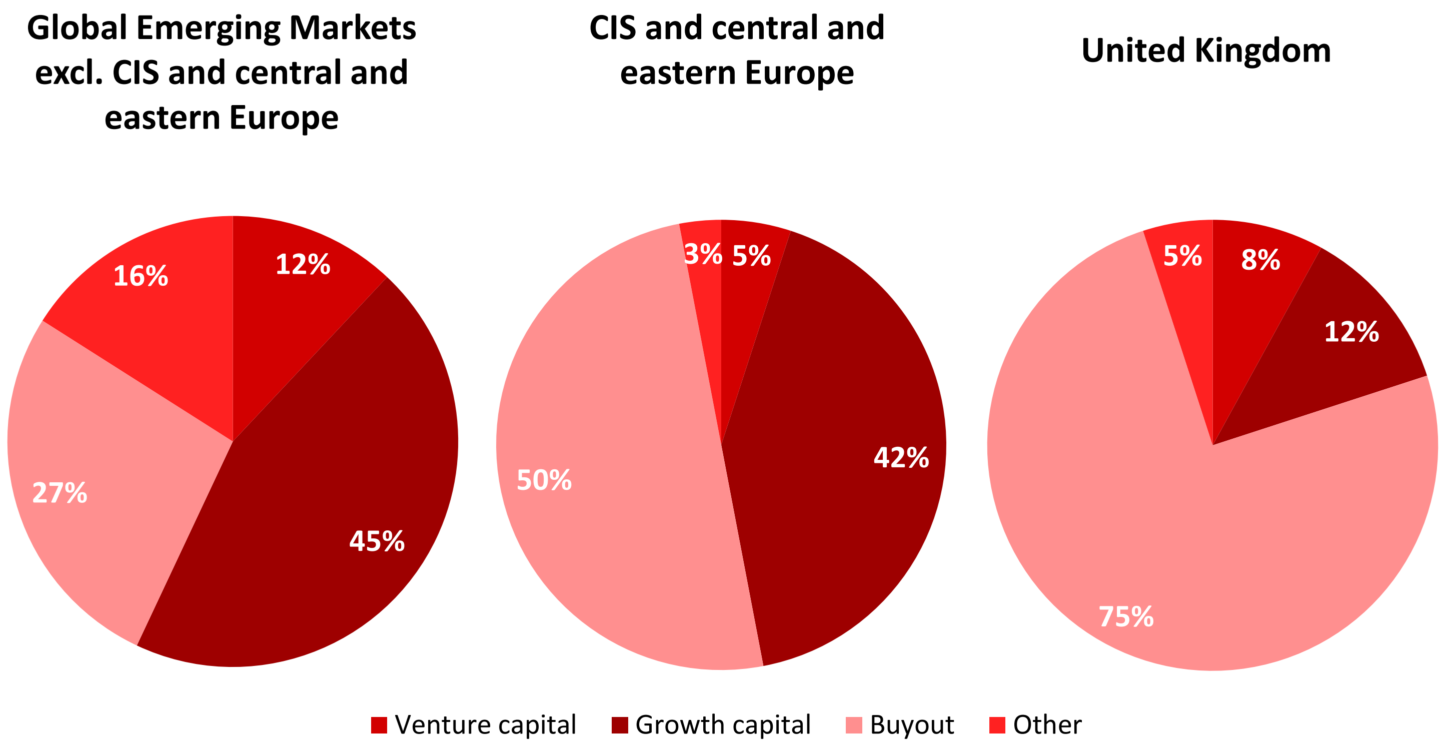
Taxation

- Tax incentives or direct support (grants) can contribute to lowering risk in SMEs and start-ups. Capital gains tax upon disposal is the key variable; income taxes are less relevant in the start-up phase
- Tax incentives are common in advanced countries, and can be effective (EC, 2017). Upfront tax credits or loss relief are common
- Best practice with regard to scope, eligibility, and generosity:
  - Set high-level criteria, avoid picking winners
  - Clear eligibility criteria in terms of investment size, duration, inclusion of cross-border investment
  - Lower risk, e.g. upfront tax credits
  - Use performance indicators (e.g. tax relief on future returns)
  - Constrain tax avoidance (e.g. related party transactions)
  - Define a predictable regime, monitor fiscal costs

4. The investor landscape in emerging Europe

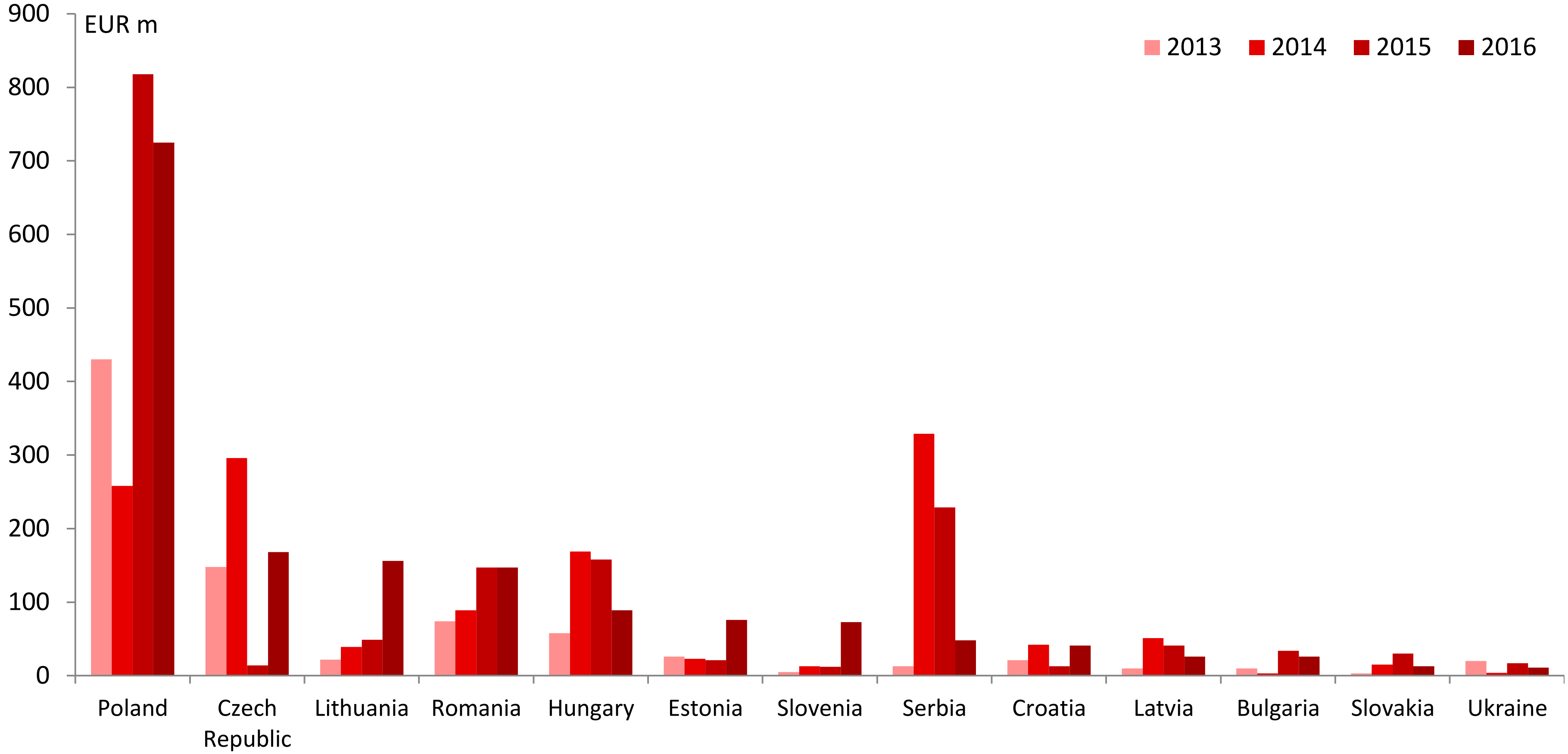
- VC is normally a very small share of overall SME financing
- The EU VC market is itself underdeveloped, depth is only about 12 per cent of that in the US
- The sharp drop in global flows after the financial crisis has only partially been made up
- CEE region still underserved by PE/VC: EBRD estimates number of suitable firms at 40,000, compared to only 800 recipients to date
- Poor corporate governance and protection of minority shareholders the key constraints
- Investor activity concentrated in central Europe, Russia and Turkey
- Invest Europe figures for fundraising/investment in CEE: € 620 m/€ 1.6 bn for total PE and only € 100 m raised for dedicated VC (16% of total CEE PE)
- Poland and Hungary accounting for over half of the total

Breakdown of private equity deals by type, 2009-14



Source: EMPEA reproduced in EBRD, 2015

Private equity activity in emerging Europe



Source: Invest Europe, CEE Private Equity Statistics 2016

5. Public sector VC involvement: possible rationale and pitfalls

- There are potential rationales for public sector involvement in venture capital:
  - Lower costs of capital, and longer investment horizon compared to private investors (with an IRR of 15-20%)
  - The potentially difficult exit (after 5-7 years) in an as yet illiquid local market is less of a concern
  - Lower costs of due diligence in scrutinizing the large number of potential investee companies, e.g. due to prior involvement or the pre-existing local presence
  - Official VC funds will be less deterred by regulatory risk, or be less exposed to it
  - Support through a public sector VC fund may make abusive conduct by company insiders less likely (a lower risk of ‘tunneling’)

Pitfalls from public VC involvement

Equally, there are important risks:

- Policy objectives can prevail over sound investment analysis. Well-connected individuals seek to influence allocation
- Governments rarely have the necessary expertise to target specific firms, technologies or sectors. Skills constraint is more of a problem compared to international PE/VC funds
- Risks in the concentrated portfolio and long-term investment objectives will ultimately not be politically supported
- Innovation finance requires a chain of financing for all stages of development beyond the start-up phase, including PE type growth financing. In the absence of commercial funds and expertise at the later growth stages, public VC support may be futile

Context in Belarus

- Considerable innovative potential in the startup sector
- Conditions for IT companies more attractive through December 2017 law ”On Development of a Digital Economy”
- VC sector only just emerging: 5 local VC funds, and about 10-20 business angels. Estimated startup investment of USD 100 m. in about 100 deals was significant in a regional comparison
- Bank SME lending constrained by risk aversion, high levels of NPLs, and limited expertise/capacity
- Established European PE/VC funds near absent, though acquisitions by Facebook and Google internationally noted
- Tax benefits, and clearer legal framework in High Tech Park, though corporate governance standards very weak (EBRD, 2017)

6. The experience of development institutions: multilaterals

European Investment Fund (EIB)

- Pan-European VC Funds of Funds programme. Up to EUR 300 m for between 7.5 and 25% of total commitments (no recent evaluation)

EBRD

- Venture capital investment programme. EUR 100 m for direct and indirect investments, only alongside qualified co-investors
- Early-stage innovation facility. EUR 100 m
- Good impact in supporting the PE industry in the region, and in governance and operational changes in investee companies
- A questionable financial return (significant unrealized losses in past three years)

Also a large number of national funds

- EU estimates that in 2014, 30 % of European VC came from official sources. Examples of EU business growth funds:
  - Germany (KfW). Three separate funds: directly for start ups, indirectly into VC funds, and into companies in the growth phase, alongside a private lead-investor
  - France: Bpifrance provides seed capital, in particular for R&D projects
  - Spanish ICO promotes privately managed VC funds. Aim is to establish 40 new PE/VC funds with up to EUR 4 bn. Invested in Spain
- Ukraine UNSF fund: HRV 50 m p.a. for early and roll-out phases, co-investment from outside funds is sought, tranche sizes of USD 25-75 thsd. targeted

7. Organizational issues

VC segment is ripe with risk. Risks are elevated in Belarus due to poor corporate governance. There are two overriding priorities:

- Draw on private sector expertise: through involving private investors in project selection, structuring and monitoring
- Share risks: by investing directly alongside private investors - and in later phases investing in PE/VC funds, both on a ‘pari—passu’ basis

Implications:

- Seek to attract a recognized co-investor, e.g. from established private finance agency or bilateral donors
- Allow a wide range of sectors and types of start-ups to be eligible for the proposed programme
- Application and selection process should be clearly structured and be based on transparent criteria

8. Financing and governance issues

Funding and potential risks to the budget

- The funding programme could be quite limited for the first several years (EUR 5 m), given small tranches
- Funding should be through a combination of subordinated (mezzanine) debt and limited equity
- The Development Bank is not an ‘angel investor’: it should retreat, rather than scale up, where the investee company succeeds. Convertible bonds (offering the option to buy into future equity raising at a discount) are therefore not sensible

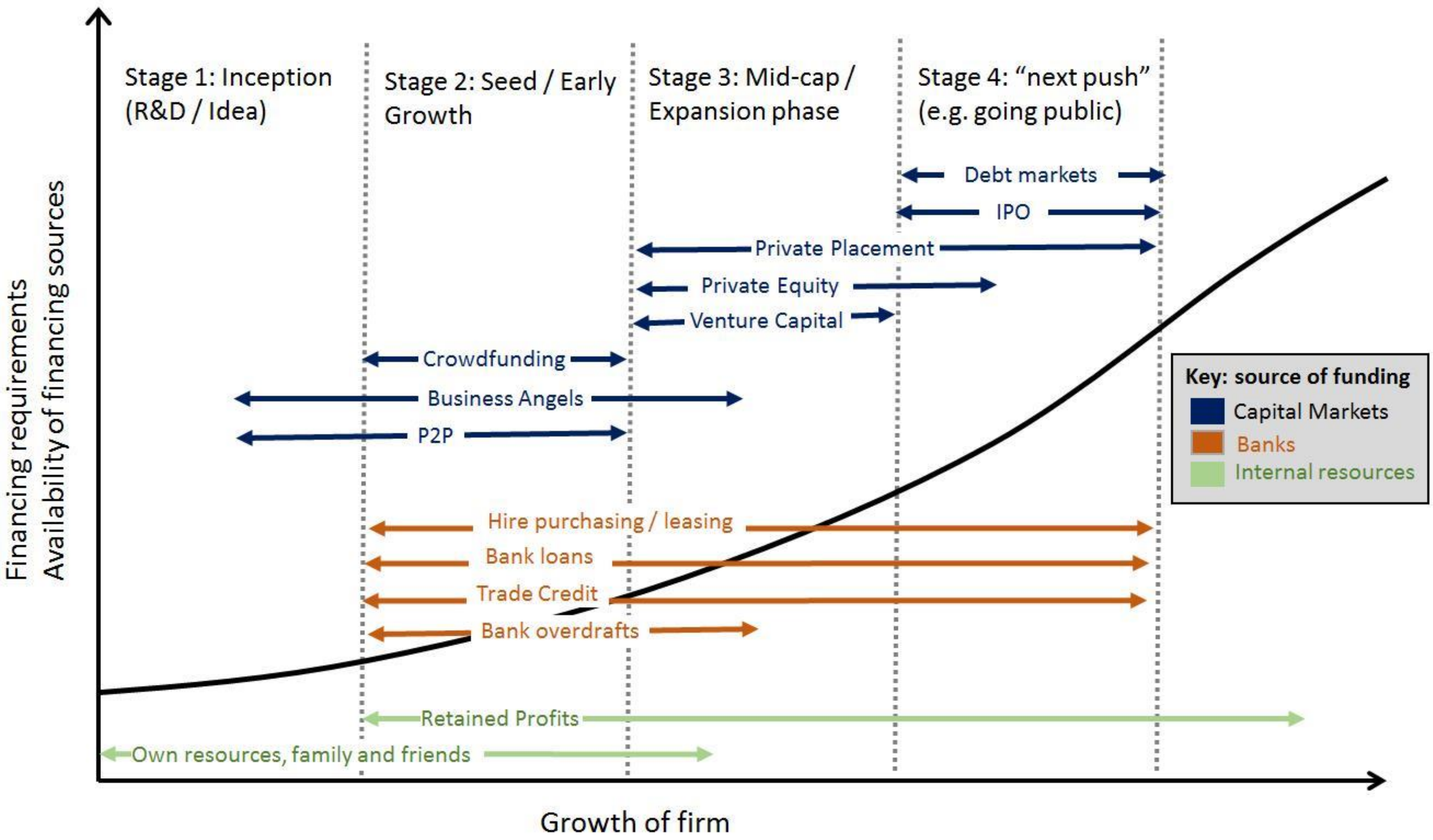
Organisation and legal aspects

- Initially VC unit would need to be within the Development Bank (on its balance sheet), as this ensures close supervision
- Independent investment committee with international professionals should select projects

9. Conclusions and next steps for the Development Bank

- A VC fund in the Development Bank could bridge certain market failures, and have a useful demonstration effect, especially in the start-up phase for companies
- Established PE/VC investors may be attracted, though only once a ‘track record’ has been established
- Regulatory framework conditions, in particular legal enforcement and corporate governance/shareholder protection, need to be reformed in parallel. The subordinated status of the Development Bank VC debt needs to be legally clarified
- Official VC funding will be most productive in seed finance (pre-commercial application), and even more so in the later ‘growth’ phase where a proven concept exists.
- VC/start-up funding cannot be tackled in isolation. The wider innovation financing ‘ecosystem’ needs to be developed, including PE type growth finance
- An official VC role should maximise risk sharing with the private sector, and draw on its expertise as much as possible

The funding escalator



Source: European Commission

… next steps

- Consistent application of Digital Economy Law is needed, but privileges in HTP and other export zones need to be widened, and sector limitations lifted
- Early stage investee companies will require functional and technical expertise – programmes such as small business development should be scaled up
- The Development Bank could host seminars for start-up entrepreneurs with VC/PE funds active in the region
- Contact established multilateral VC investors (EBRD), and private investors (e.g. Earlybird’s Digital East fund) to assess potential and market failures
- Design operational guidelines, investment criteria in coordination with an established public agency from the central Europe region

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