Building a venture capital sector in Belarus: State participation, tax incentives and accelerators

Alexander Lehmann

German Economic Team Belarus

Berlin/Minsk, April 2019

Outline

Based on the Committee's questions we deal with three areas in this presentation:

I. State participation and tax incentives in the creation of a venture capital sector
II. High-tech and fast-growing companies and local capital markets – incentives for issuance and trading
III. Business angels, incubators and accelerators

References

Contacts

I. State participation and tax incentives in the venture capital sector

Public sector VC participation: possible rationale

- Lower costs of capital of the state, and longer investment horizon compared to private investors (who seek 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 for state-backed investors
- 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 insiders in a private company less likely

Equally, there are many risks and pitfalls

- Policy objectives can prevail over sound investment analysis. Well-connected individuals seek to influence allocation
- Governments rarely have the necessary expertise to identify promising technologies, firms or sectors. Skills constraint will be more of a problem compared to international PE/VC fund
- Risks in the concentrated portfolio and long-term investment objectives will ultimately not be politically supported
- Innovation finance requires a chain of financing <u>for all stages</u> 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

State participation is common in the EU venture capital sector

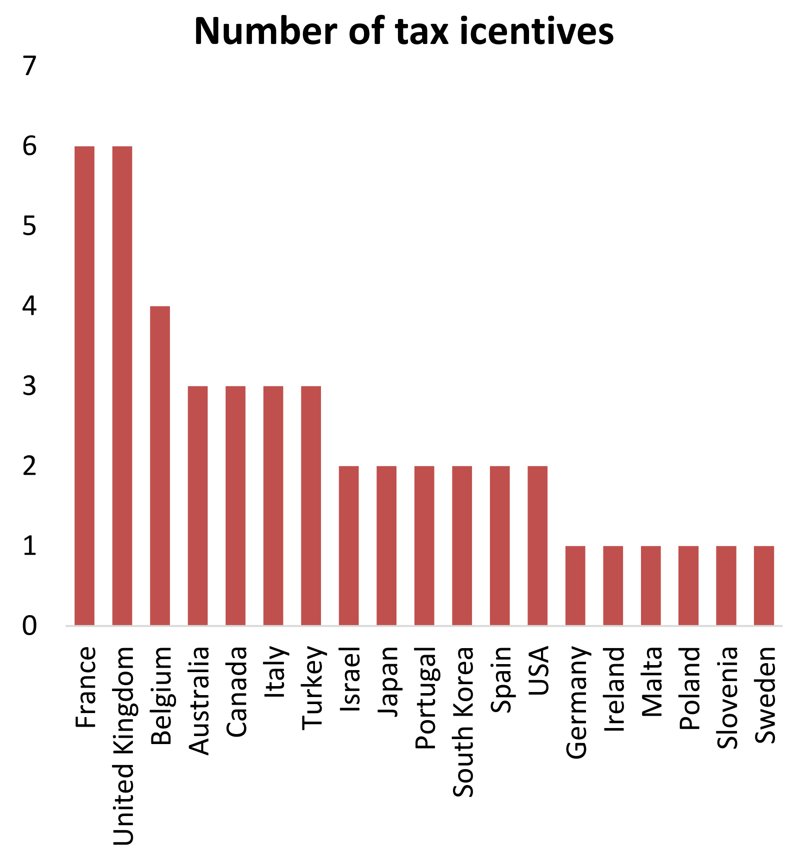
- EU estimates that in 2014, 30 % of European VC came from official sources. Examples of EU business growth funds:
  - Germany (KfW). Three separate funds: directly for start ups, indirectly into VC funds, and into companies in the growth phase, alongside a private lead-investor
  - France: Bpifrance 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

Taxation of VC investors: general principles

- Economics predicts that a higher corporate income tax relative to the personal income tax will discourage entrepreneurial activity
- Tax incentives or direct support (grants) can therefore contribute to lowering risk in SMEs and start-ups. This will concern the entire life-cycle:
  - Income during holding period: start-ups are typically loss-making, though favourable loss-relief could reduce risk and provide incentive for entrepreneurship
  - Capital gains tax important once the investor seeks to divest
- But the level of taxation does not seem to strongly affect VC activity: some advanced countries with high corporate taxes have significant VC sectors, many emerging markets with low corporate taxes have none.
- In practice, VC investors are most concerned about transparent and predictable taxation that is efficiently administered.
- Capital gains tax upon disposal is the key variable; income taxes are less relevant in the start-up phase

Tax incentives in the EU

- Older (core) EU countries more likely to target the VC sector; new EU countries in central Europe provide incentives through a lighter general tax system
- Where they used, incentives are available for both VC and business angels
- Upfront tax credits or loss relief are common
- Qualifying criteria vary in complexity to target specific businesses, investors or holding periods
- Generally little discretion used in determining eligibility



Source: EC (2017).

With any further preferences Belarus should follow best practice as much as possible

Qualifying criteria

- Clear eligibility criteria based on business age and size
- Avoid targeting specific sectors
- Include both business angels and venture capital investors, also foreign investors
- Restrict participation of related parties

Scope

- Relief on capital gains, and more favourable loss-relief to qualifying investors
- Use performance indicators (e.g. tax relief on future returns)
- Constrain tax avoidance (e.g. related party transactions)

Administration

- Set high-level criteria, limit discretion
- Do not signal excess generosity
- Define a predictable regime, monitor impact and fiscal costs

II. High-tech and fast-growing companies and local capital markets – incentives for issuance and trading

Benefits to capital market development

- Venture capital firms, as private equity firms, rarely list on public markets
- Exit from investee companies is generally to other investors or to industrial investors (‘trade sale’)
- Public listings of investee companies is rare in emerging Europe, but also in western Europe. Often, more liquid foreign markets are more attractive than local ones

➢ The emergence of high growth firms and start-ups will have limited benefits for capital market development in Belarus

Exit options from private equity and venture capital investments in Europe and CEE markets (2017, share of exit value)

Source: Invest Europe

CESEE stock exchanges

- All CESEE countries have an exchange and capitalisation is sizable, though IPOs are now very few and highly concentrated. Warsaw is the only exchange which attracts foreign IPOs, including from Ukraine
- Turnover is also increasingly concentrated in Warsaw, Budapest and Prague
- Some cross-border alliances (e.g., Baltics, SEE Link or Prague-Vienna)
- All exchanges have their central securities depositories (CSDs), though only Poland and Hungary have EMIR-compliant CCPs. A fragmented post-trading infrastructure not conducive to cross-border trading
- Experience of stock exchange is in line with World Bank research, showing that early growth and liquidity are key factors in long term success, and that many exchanges eventually shrink (Albuquerque et al., 2016)

CESEE stock exchanges

Country	Name	Capitalisation, EUR m	Turnover, EUR m	Share turnover ration, %	Number of domestic listed companies	Number of foreign listed companies	Number of Initial Public Offerings (IPOs)
Bulgaria	Bulgarian Stock Exhnge (BSE – Sofia)	4,417	156	4%	365	0	1
Czech Republic	Rague Stock Exchange (PSE)	40,721	6,213	15%	15	10	1
Estonia	Nasdaq Tallinn	1,888	149	8%	15	0	0
Croatia	Zagreb Stock Exchange (ZSE)	16,834	387	2%	186	0	2
Latvia	Nasdaq Riga	1,277	45	4%	26	0	0
Lithuania	Nasdaq Vilnius	3,339	75	2%	29	1	0
Hungary	Budapest Stock Exchange (BSE)	16,246	7,005	43%	45	0	0
Poland	Warsaw Stock Exchange (WSE)	123,659	56,256	45%	838	64	49
Romania	Bucharest Stock Exchange (BVB)	17,027	1,865	11%	82	2	0
Romania	SIBEX	N/A	N/A	N/A	N/A	N/A	N/A
Slovenia	Ljubljana Stock Exchange (LJSE)	5,523	340	6%	46	0	0
Slovakia	Bratislava Stock Exchange (BSSE)	2,119	6	0%	14	0	0

Source: EBCI (2018)

Which firms could issue bonds?

- In general a firm is more likely to issue on a domestic bond market if it is:
  - Relatively large
  - Growing with a substantial investment programme
  - At or above investment grade
  - With a record of a syndicated loan
- On the international market issuers are:
  - larger
  - more leveraged

- Specific issues for SMEs and most firms in the CEE region:
  - Median size of issuer has gone up since the financial crisis
  - Issuance costs relative to deal size could be substantial
  - Coverage by international rating agencies is patchy
  - Transparency of accounts and auditing?
  - Obstacles from investment mandates of institutional investors

Sources: Empirical studies reviewed in OECD (2015)

Policy priorities for bond market development

Primary market framework

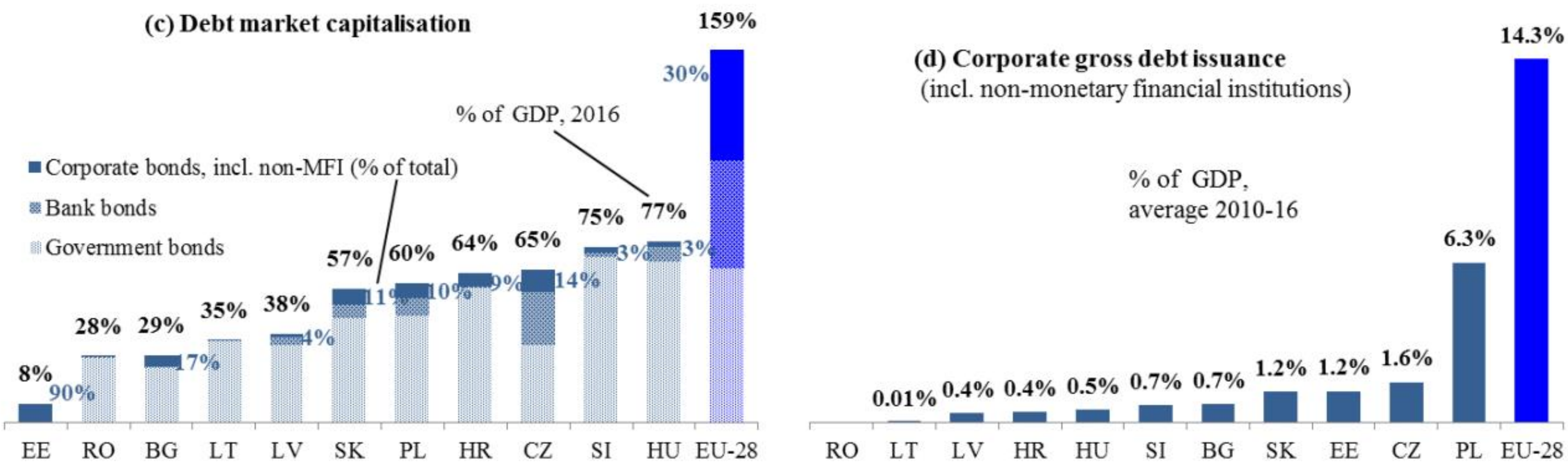
- Facilitate issuance through light disclosure requirements, and registration requirements
- Adapt the framework to the issuer base: large repeat issuers, SME first time issuers, and special projects (infrastructure)
- Offer simplified disclosure regimes for private placements

Secondary market framework

- Private bond trading develops on the back of a liquid sovereign market that extends over a range of maturities.
- Corporate bonds inherently less liquid than sovereign issues, given a largely ‘buy-and-hold’ investor base
- Make trading systems easily accessible for eligible market participants
- Ensure transparency, at least following a trade, through centralized reporting (e.g., on a CSD)

Source: IMF (2013)

Corporate bond market development in the CEE



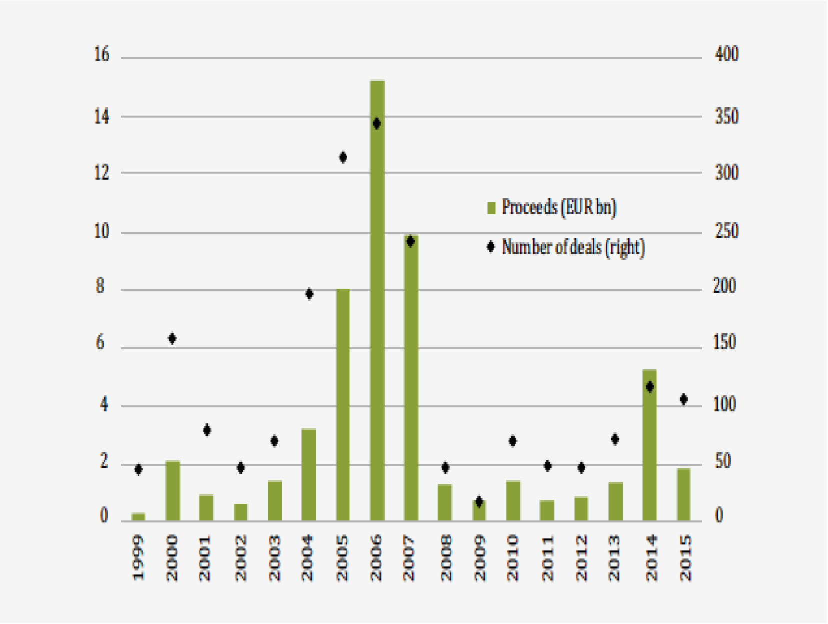
Source: : [Vienna Initiative CMU report (2018)]

Why incentives for issuance and trading may be needed for SMEs and high growth firms

Issuance and trading of equity of SMEs, including start-ups, could be facilitated through a more permissive regime. The economic rationale:

- Fixed costs in underwriting fees, legal and listing costs are disproportionate to the benefits accruing to the issuer in terms of financing costs, maturity, investor base etc.
- The need for investor protection (from ongoing disclosure) and market integrity (e.g. through preventing abuse of insider privileges) is not the same as for larger enterprises
- Benefits from liquidity in markets reduces the cost of capital for all companies listed.
- Benefits in governance through involvement of new investors are not wholly captured by the issuer

IPO proceeds and number of deals on European junior markets



Source: AFME

SME listing and trading support in the EU

- In the EU about 1,500 companies are listed on ‘junior exchanges’. E.g. ‘New Connect’ within the Warsaw Stock Exchange. Issuance by SMEs has declined since the financial crisis
- EU and national facilities already support SMEs in the pre-IPO phase to upgrade accounting quality and corporate governance of potential issuers

New EU capital market regulation is adapted with a less onerous regime for SMEs:

- A lighter regime for financial instruments issued by SMEs is in place under the Prospectus Regulation
- The financial instruments directive (MiFIDII) already designates SME growth markets
- Proposals aim to lighten compliance costs under Market Abuse Regulation (on insider trading) for such SME growth markets

Implications for Belarus:

- In the early phase of capital market development building liquidity is the priority, given an common acceptable standard for investor protection and market integrity. A separate regime does not make sense at this stage
- Companies should be supported for a potential issuance in terms of corporate governance, accounting quality etc.
- A differentiated tax treatment for listed companies does not seem sensible

III. Business angels, incubators and accelerators

The business angels and their associations

- Business angels are high net worth individuals who directly invest part of their assets in start-up enterprises
- They contribute specific industry knowledge and contacts and will typically be involved through a non-executive board position
- Business angels begin to provide funding after family and friends have provided capital but they are ahead of more formal VC funds. Small individual investments (estimated in the EU at EUR 20,000)
- Most EU states have business angel associations
- Often co-investment is provided by the public sector. Mostly national, though some cross-border investment by a fund of the European Investment Bank
- Networks play a key role in upgrading capacity of investors

Tax incentives for business angels

- 12 EU states offer tax incentives for business angels, which differ widely, discouraging cross-border investment:
  - Often benefits for VC and business angels investing directly or through an investment fund
  - Also: incentives to investee company (eg exemptions on salaries)
  - Tax reduction for investments in shares of start-ups and SMEs (eg. Belgium, Finland, UK, Ireland)
  - Reduced taxes on dividends or capital gains (eg Italy, UK, France)
- Business angels must qualify for these incentives

Source: EBAN (2017)

Incubators and accelerators

- Incubators and accelerators combine physical space with business support services and mentoring. University affiliation is particularly effective. Business angels, VC funds and private investors (family funds) are typically involved in the management of incubators/accelerators
- Only very early stage companies are targeted. Typically up to five years for incubators, and six months for accelerators
- Some limited access to finance may be involved. Small sums in large number of start-ups in regular intervals, often in return for share in the equity. Overall individual investments are very small (estimate for EU 2015 total only EUR 37.5 million in about 2,500 start-ups), though the sector is rapidly growing
- Empirical studies confirm that accelerators increase company survival rates, revenue and employment growth

Policy considerations for Belarus:

- ➢ Only most mature start-ups are likely targets for VC funds
- ➢ Critical mass is required. Networks to foster partnerships among start-ups particularly effective
- ➢ Public support needs to be based on effective selection mechanism. Belarus already offers a generous support through the High Tech Park

Experience with accelerators in Germany

- Over 1,100 support offers for start-ups in Germany
- Public and private accelerators, monetary and in-kind support

Supply side trends:

- Proliferation of offers reduces transparency and quality differences
- Differentiation in terms of technologies, sectors or lifecycle
- Boundaries between different models (incubators, accelerators, co-working spaces) are blurring
- Growing international linkages

Demand side trends:

- Higher demand and expectations
- Start-ups place high premium on credibility of the accelerator as independence increasingly important

References

- AFME (2017): The shortage of risk capital for Europe's high growth businesses.
- EBAN (2017): Compendium of fiscal incentives: tax outlook in Europe, business angels perspective.
- European Bank Coordination Initiative (2018): Report on Capital Markets Union.
- European Commission (2017): Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups.
- Startup investment and innovation in emerging Europe.
- IMF (2013): Local currency bond markets – a diagnostic framework.
- Invest Europe (2018): CEE market statistics.
- Goswami,A. D. Medvedev, and E. Olafsen (2019): High growth firms: fact, fiction and policy options for emerging economies, The World Bank.
- OECD (2015a) *Growth companies, access to capital markets and corporate governance*. OECD report to G20 Finance Ministers and Central Bank Governors.

Contacts

Dr Alexander Lehmann

lehmann@berlin-economics.com

Dmitry Chervyakov

chervyakov@berlin-economics.com

German Economic Team Belarus
c/o BE Berlin Economics GmbH
Schillerstraße 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
www.get-belarus.de
Twitter: @BerlinEconomics
Facebook: @BE.Berlin.Economics