ГОСУДАРСТВЕННЫЙ КОМИТЕТ ГКНТ ПО НАУКЕ И ТЕХНОЛОГИЯМ

UNECE

Concluding seminar

Options for delivering risk capital to innovative enterprises in Belarus

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Report

Online, KUDO platform

Background

Securing financing is important for innovative firms – and vital for enabling and promoting innovation for sustainable growth and development. Insufficient or inappropriate means of external finance often compound the risk inherent in innovation and constrains the broad experimentation with new ideas that is essential for Belarus to reach the Sustainable Development Goals (SDG).

Governments across the region, including in Belarus, have put in place a range of measures to enable, facilitate, and subsidise innovation and entrepreneurship – from subsidised loans and loan guarantees to vouchers and outright grants. Many of these efforts, as, *inter alia*, the 2017 UNECE Innovation for Sustainable Development Review (I4SDR) of Belarus shows, have not had the intended effect of ensuring that experimentation takes place that would not have taken place otherwise, and that functioning, sustainable markets emerge. As a result – a growing concern not only because the importance of innovation in Belarus, but also because of the need to ensure that fiscal resources are used as efficiently as possible.

An important part of the efforts to reform Government policies to enable and subsidise access to finance for entrepreneurship and innovation in the economy is the aim to develop a functioning market for equity financing of innovative, risky initiatives with large potential private and, most importantly, social returns (in the shape of demonstration and spill-over effects, employment, creation of new sectors, and fiscal revenue). Equity finance, in contrast to debt-based instruments, is much better able to finance these types of initiatives – although most innovative projects in which venture capitalists invest fail, the minority of investments that succeed generate returns that compensate for those losses, if they are part of a diversified portfolio and run by experienced fund managers.

The Government can provide an impetus to the development of markets for different types of equity financing, including venture capital and, at later stages, public listings. The most important piece of the puzzle is to get the rules of the game right and ensure transparency of legislative and regulatory frameworks, and balanced investor protection. While Belarus is already working towards this end[1], the joint Belarus-UNECE work stream looks at one important complementary measure: how the Government could partner with investors and intermediaries to set up a pilot mechanism for investing in innovative projects in the private sector that would absorb potential losses in exchange for a proportionate share of potentially substantial returns from the projects that succeed. Operating on commercial principles and managed independently based on a simple SDG-related public mandate that defines and circumscribes target investments, this arrangement would support private sector innovation and could be used to facilitate and catalyse more venture capital investment in innovative projects in Belarus. This would have several distinct advantages, including the ability to outsource investment decisions and asset management to private investors, and the possibility to capture some of the returns of successful projects through direct or indirect equity stakes.

Purpose of the seminar

Based on the long-standing relationship and the 2018 UNECE-State Committee for Science and Technology (SCST) MoU, and with financial support from Sweden, this webinar serves as the capstone of a two-year capacity-building programme on promoting and defraying the risk of financing private sector innovation, especially through equity mechanisms. The programme is part of the Inter-sessional

[1]SCST and the Development Bank of Belarus have formed two working groups to work on venture capital

Implementation Plan for 2019-2020 of the UNECE Committee on Innovation, Competitiveness and Public-Private Partnerships[2].

The first two workshops under this programme, in May and December 2019, explored access to finance needs and basic principles for public-private venture capital funds and how these principles, along with lessons learnt from similar initiatives across the world, could be applied in Belarus. A concept note was prepared by UNECE experts in consultation with the local task force on Public-private venture capital funds for innovative projects. The concept note informing the discussion of this webinar details several models of equity-type mechanisms with government participation. This webinar concluded this programme and served to present and discuss this concept note as well as next steps.

Participants in the webinar included policy makers, government officials, investors, financial institutions, innovative private and state-owned enterprises, potential entrepreneurs, enterprise support institutions such as incubators and technology parks, R&D organisations and universities participated in the seminar (see Annex 1: list of participants)

Summary

In presenting opening remarks, Mr. Shumilin, Chairman of SCST, highlighted the efforts undertaken by the government to develop the country's innovation infrastructure and the regulatory framework for innovative entrepreneurship and venture capital regulatory acts. In this context, the international experience and the UNECE recommendations would be very useful. Ms. Kazana, UN Resident Coordinator in Belarus, highlighted the importance of innovation to ensure sustainable development and deal with events such as the COVID-19 pandemic: "*private finance will be crucial as we move from the immediate health response to a bolder and more ambitious 'building back better" recovery, which will focus on socio-economic and social transformation"*.

After the opening interventions, the **first session** began with a presentation of the three leading options for public-private mechanisms for providing equity capital to innovative and risky projects, resulting from the analysis and previous discussions with a dedicated task force. The options included:

- 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.

These models have proven effective in, *inter alia*, the US and Israel in the early stages of development of the venture capital market. In terms of legal and operational complexity, the equity carry model is the simplest and has proven useful in countries with relatively underdeveloped capital markets (e.g.

[2] Available at https://www.unece.org/fileadmin/DAM/ceci/documents/2019/CICPPP/Official_documents/ECE_CECI_2019_8_1900973E.pdf

Tunisia). But it also has spill-over effects, in terms of promoting the development of a domestic VC sector and enhancing competition among potential VC investors.

The other two, the *co-investment* and funds of funds models, require the presence of already established innovation infrastructure, including active business angels and VC investors, in addition to a more advanced legal and operational 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.

Another option is to establish and experiment with multiple mechanisms on a limited scale, which would allow meeting multiple demands and yield important data on what works, what needs to be changed, and what should be discontinued or scaled up. As long as the capital is directed to ventures that otherwise would likely not have access to external equity funding but which carry substantial potential of positive social return, the number and type of funds are not crucial.

The three models presented 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. This requires an integrated approach for financing innovative projects. Alongside financial assistance measures, broader efforts to enable and sustain a pipeline of projects that show the potential and maturity for external equity funding are equally important – including improving the business environment, supporting the early stages of entrepreneurial development, building absorptive capacities among SMEs and entrepreneurs, and promoting linkages and internationalization.

Choosing among the three options depends on the government's objectives, priorities, and institutional capacities. To achieve this objective, some funds could be 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.

The Government's objectives also determine which institutions should be involved in setting up a VC fund. The institution in charge of VC fund development needs to understand the policy and financial implications (e.g. have the capacity to manage the investment), with a ministry generally having only a supervisory role. The first steps in this direction include conducting a feasibility study and broader inter-agency and public-private consultations in order to identify the institution in charge to set up and operationalize a public-private fund.

In all three models, direct equity financing by a public entity can be complemented through different guarantee instruments to subsidise part of the downside risk that private investors face or perceive. 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. Guarantees are attractive for public authorities as they do not involve the immediate allocation of state funds. They are attractive for the private VC investors only if they provide coverage against risks equal to direct equity investment and enable private investors to gain access to long-term borrowing from banks and financial institutions at attractive rates.

In piloting these models, international financial institutions (including the Eurasian Development Bank, EBRD and IFC) could play an essential role. They can advise governments on how to structure funds to make them attractive for private investors, provide equity and debt leverage in the initial phases, provide, through their own due diligence process, an important stamp of approval that signals

confidence to private investors, and help reach out and structure deals with them. For example, the European Investment Fund has been instrumental in the development of the VC industry in several new EU member states and Turkey. Another example is the Western Balkans Enterprise Development and Innovation Fund, which included a multilateral arrangement (EIB, EIF, EBRD) to set up a regional fund providing both equity investment and loan guarantees to innovative and fast-growing enterprises.

The second session discussed on-going initiatives and priorities in the area of risk capital. The Eurasian Development Bank showed interest in supporting and participating in a public-private VC initiative. The bank's current activities include long-term social and infrastructure projects. In addition, its Technical Assistance fund aims at supporting highly innovative and technology transfer manufacturing projects (e.g. feasibility study, national and international marketing analysis, training programmes). Other instruments include partial guarantees and equity acquisition activities, which help substitute for the lack of venture capital in the country on a payback basis. More recently, it launched a Fund for Digital Initiatives, focused on the IT sector rewarding the best digital solutions countering the pandemic's negative effects in the Eurasian territory (applications are open until end-October.)

The Advanced Instrument Manufacturers Association highlighted the need for support at all stages of the life-cycle of innovative firms. Particularly important are mentoring and access to finance at the very early stage to define the idea and understand the market needs. This kind of innovation support is nascent in Belarus, but focusing mainly on non-risky ventures. Unsuccessful projects provide important spill-over effects, allowing the country to experiment, learn and build trust between private and public entities.

BelBiz provided an update on USAID's funded project focusing on venture capital legislation and ecosystem development. Based on surveys with the private sector and government agencies, and following international best practices, BelBiz developed recommendations and legal drafts supporting the development of a VC system. The recommended drafts have been shared with state bodies for their consideration. Training for lawyers on structuring deals and VC financing tools has also been part of the project.

In his concluding remarks, the SCST's First Deputy Chairman highlighted the new science and technology programmes envisage further grant opportunities for start-ups and SMEs. To develop the VC market, there is still a lot to be done. One needs to take into account the structure of the country's economy. This needs the cooperation of government, private sector and international organisations.

Key messages

- A public-private fund, if done well, would help catalyse a vibrant risk capital market in Belarus, while also ensuring efficient use of scarce public resources and building trust among stakeholders and investors;
- The mandate of the public-private fund should be formulated with a focus on social return – the net potential positive benefits for the economy and for sustainable development;
- Choosing among the three risk capital options depends on the government's objectives. In this respect, it is important to differentiate the needs at different stages (from seed to exit);
- International financial institutions could play an important intermediary role in advising on, piloting, and providing seed capital and debt leverage for such a mechanism;
- Facilitating access to finance for high-risk ventures requires an integrated approach to enabling and promoting private sector innovation and ensuring a strong pipeline of attractive investment opportunities;
- Belarus is at a crucial intermediate stage: it has an emerging, active and professional business angels and VC sector, a semi-developed legal framework, a growing start-up scene, and an

educated labour force – but it lacks a liquid and diversified capital market and it is characterised by a low level of mutual trust between the government and entrepreneurs and investors operating in the technological advanced sectors;

- The next steps involve a wide process of consultations with entities that may play a role in finding solutions to long-term financing for innovative companies. This can be done, inter alia, by expanding the existing mechanisms, such as the SCST Working Group. This should lead to the identification of a realistic option among the options discussed, with broad public and private support. The government should then identify the leading institution to be in charge of the project's development and launch an in-depth feasibility study, looking at the economic, financial, legal and operational implications, before moving ahead with the allocation of financial resources.

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