

# Capital opportunities

Smart money for ambitious entrepreneurs

Advisory report 76

## Summary

### Background and request for advice

Fast-growing innovative companies make an important contribution to the development of the Dutch economy. These companies often rely on external funding. Raising private capital is relatively difficult, however, especially for young innovative companies. Given the increasing importance of fast-growing innovative companies to the economy and in light of the recent financial and economic crisis, the Minister of Economic Affairs, Agriculture and Innovation asked the Advisory Council for Science and Technology Policy (AWT) to issue advice with respect to the following question: *How can access to private (risk) capital for (fast-growing) innovative companies be improved?*

In providing the present advice, the Council first analyses the problem prior to setting out an overview of current government policy, in which more than 20 instruments are described. The Council then proceeds to identify problem areas that remain in spite of government policy. The advisory report ends with five recommendations.

### The problem: the ‘valley of death’

To raise private capital, companies can approach banks for credit or venture capitalists for risk capital. Companies’ funding problems appear to be greatest in what is known as the ‘valley of death’, that is, during the phase following a company’s start-up and prior to its commercialisation, when the market is entered. The need for external funding is greatest during this phase, while the availability of private capital is lowest, a situation referred to as the ‘equity gap’.

Banks and venture capitalists make their investment decisions based on the relationship between return and risk. Banks focus mainly on the risk that a recipient may be unable to

repay the credit provided. For banks, securities and cash flows are essential. Young innovative companies in the ‘valley of death’ often do not have the securities or cash flows required, or it is otherwise prohibitively expensive to acquire insight into the matter, as a result of which banks often refrain from providing credit during this phase. A venture capitalist focuses far more on growth potential based on the business plan and the ambition and qualities of the entrepreneur or entrepreneurs involved. In addition, a venture capitalist estimates the risks: can these be controlled and can he or she play a part in this regard? If a venture capitalist decides to invest, he or she also takes up a controlling position in the company in order to exert influence on the control of the risks, for instance by making his or her own knowledge, experience and networks available (risk capital is referred to as ‘smart money’ for this reason). Finally, a venture capitalist assesses the possibility of selling the investment after a number of years (the exit opportunity). If doing so is not possible, the venture investor will not get involved. In other words, venture capitalists may therefore also have reasons to refrain from investing in the ‘valley of death’ phase.

### **Current government policy**

Due to the positive external effects of innovation and growth, and because the capital market can fail as a result of information asymmetry between an investor and a company, the government has a legitimate part to play in improving access to capital for companies that wish to innovate and grow. The Council has prepared an overview of approximately 25 instruments currently being used by the government to improve access to capital. The current capital market policy ties in well with the operation of the capital market, focuses on the problems referred to above and has proven itself to be effective.

The government provides security and covers part of the risk through guarantee schemes for banks and venture capitalists. It also reduces risks through the TechnoPartner SEED facility by providing loans to venture capitalists. In addition, the government takes over part of the technical risk through its Innovation Credit Scheme, as a result of which venture capitalists and banks invest in companies that they would otherwise not invest in. Moreover, in a range of Small Business Innovation Research (SBIR) Programmes, the government supports companies directly as a commissioning party for the development of new products and services. The Innovation Credit Scheme and SBIR Programmes help to make companies ‘investment ready’. Both instruments lack the budget to support all good proposals, however. Another instrument for the capital market is constituted by the Regional Development Agencies (RDAs). RDAs are responsible for almost half of the number of early-phase investments.

### **Current problem areas**

The current policy does not resolve all of the problems for companies seeking external funding. Improvements must be made primarily with respect to risk capital. Due to increasing solvency requirements, banks will hardly be able to increase their provision of credit to new innovative companies in the coming years.

The problem with risk capital is that institutional investors (pension funds, banks and insurance companies), the source of approximately half of the risk capital in the Netherlands, have in recent years provided far less risk capital to venture capitalists. It is therefore difficult for most venture capitalists to raise capital at the present time. With the

exception, for the time being, of early-phase investments, the number of new investments is falling sharply as a result.

In part, this is also because venture capitalists are not receiving a sufficient number of good business cases with sufficient growth potential. In comparison with other countries, relatively few Dutch entrepreneurs have the ambition to grow. Linked to this is an unwillingness on the part of many entrepreneurs to share control with venture capitalists. Another important reason why institutional investors are making less risk capital available is that the return on invested risk capital has in recent years been low, even excessively low, in the Netherlands and the rest of Europe. Based on a comparison between the United States, where higher returns were achieved, and Europe, we identified the following causes with respect to the lower rates: a lower supply of good business cases, a lack of specialisation and expertise on the part of venture capitalists, the passive role of the providers of capital, the limited scale, insufficient syndication and the lack of sufficient exit opportunities.

In addition to the problem areas specified above, the Council believes that the current policy is as yet not being used to its full potential. An SBIR Programme, for example, provides an excellent framework for the government to play an active role as the launching customer. The government would in this case purchase the innovations developed in the SBIR Programme and thereby develop a new market for those innovations. The potential of the RDAs is likewise not fully used, since RDAs are regionally oriented and not always open to syndication (cooperation) with other (private) venture capitalists.

### **Primary challenge: more entrepreneurs with the ambition to grow**

The Council stresses that to achieve the policy objectives relating to innovation and growth, more is required than only improving access to capital for companies that wish to grow. Above all, the Netherlands requires more entrepreneurs with the ambition to grow. The matter concerns capital opportunities and therefore constitutes an important challenge for the government. Although this challenge lies outside the scope of the present set of recommendations, the Council nevertheless advises the Dutch government to make it a policy priority.

### **Recommendations for improving access to capital**

Proper access to capital is essential to companies seeking to innovate and grow. The Council issues the following recommendations to improve access to capital. These recommendations are mainly intended for the Minister of Economic Affairs, Agriculture and Innovation.

#### *1. Continue and strengthen the current policy*

The current policy is in essence good and is also valued by banks, venture capitalists and entrepreneurs. Therefore continue the current policy and strengthen it in the following ways:

##### *...communicate even better*

Continue working on increasing public awareness of the existing schemes. Doing so would be more beneficial than introducing new schemes. Consistency in the names of instruments is an important aspect in this regard. Communicate more actively about labels like New Venture, SBIR and the TechnoPartner Label, which can serve as quality labels. Use these

labels to place entrepreneurs in the spotlight and make them visible to potential investors. Increase the status of these labels within government circles so that they simplify access to other funding instruments.

*...relax restrictions applicable to the TechnoPartner SEED funds where necessary*

Relax restrictions governing the maximum size of investments. Consider varying the limits per sector in this regard, since the prevailing limits are more constrictive in some sectors than in others.

*...allow the RDAs to cooperate more*

Allow the venture capital companies of the RDAs to cooperate more with each other and with private venture capitalists. The added value of the RDAs could be increased if they shared their capital, expertise and networks with other parties to a greater extent than is currently the case.

## *2. Increase the budget of the Innovation Credit Scheme*

Increase the budget of the Innovation Credit Scheme. The Innovation Credit Scheme improves the risk/return ratio. The budget at the present time is insufficient to support all good proposals. This instrument is in keeping with the revolving fund philosophy of the current Dutch cabinet.

## *3. Improve the investment climate for later-phase venture capital*

Improve the investment climate for later-phase venture capital (risk capital focused on investments at the end of or immediately after the ‘valley of death’ phase). This would create more exit opportunities for early-phase investments. A number of countries around the Netherlands have recently set up a fund-of-funds; that is, a large fund that invests in smaller, specialised funds of venture capitalists. In these countries, this takes place through a cooperative arrangement between national government authorities, the European Investment Fund (EIF) and private parties (such as pension funds). The recommendation in this regard is that a fund-of-funds should be set up in the Netherlands as well, with the commitment of private parties. Allow the fund to operate in line with the market and maintain an international perspective.

The following recommendations are intended for both the Minister of Economic Affairs, Agriculture and Innovation and other ministers who are responsible for the government’s purchasing policy.

## *4. Make greater use of the SBIR Programmes*

The SBIR Programmes help to make companies ‘investment ready’. The budget in the Netherlands remains small, certainly in comparison with the United States. Make greater use of this instrument.

## *5. Intensify the role of government as a launching customer*

For banks and venture capitalists, a launching customer is often a prerequisite to invest. The potential of the SBIR Programmes would be further enhanced if the government became more active as a launching customer. Intensify this role.