

Appendix V

Government Support for Venture Capital

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A growing SME sector requires increased availability of both debt and equity financing. This has been recognized by the Central government of China, which has responded by encouraging provinces and cities to establish credit guaranty companies and venture capital funds, primarily to support the development and growth of high-tech companies. These have become effective sources of financing for technology-based SMEs, and have enabled fund managers and guaranty officials to gain experience.

Despite these new sources of equity, SMEs are now financed primarily by friends and family of the entrepreneur, or in a few cases by foreign venture capital funds. A major objective of government should be to attract non-governmental sources of financing, and to encourage investment in businesses with high growth potential, whether technology-based or in traditional industries. While technology may be the field of the future, much of China's current competitive advantage in global markets is in products and services available today.

Virtually all the most developed countries in the world have programs to encourage investment in SMEs by non-governmental sources. In the most successful of these, the government support acts as a catalyst to enable the formation of privately financed, privately managed investment funds, which prove they can make an attractive return for their investors, and be self-sustaining. Successful performance with a government-supported investment fund can allow a manager to arrange later investment funds without government support.

This paper will discuss the lessons learned from international best practices in SME equity investing, and suggest a pilot program for China.

Lessons from Programs of Government Support to SME Investment

- Investment is the most truly global business there is. Investors generally make venture capital investments with a small portion of a large portfolio, and are able to invest anywhere in the world. To attract non-government venture capital, therefore, any investment opportunity must compete with all others in the world. **Since non-governmental investors seek the highest possible return consistent with the risk of the investment, government support programs should aim either to increase the potential rate of return for non-governmental investors, or reduce their risk of loss.**

- ❑ Small companies create most new jobs in most countries, and venture capital is critical to the development of high-growth companies. Consequently, most countries have programs to encourage venture capital investment, using a combination of tax incentives, and government participation in venture capital investment funds (often on a basis that increases returns to the other investors).
- ❑ Experience indicates that Government programs that encourage small enterprise development can dramatically impact a nation's economy. Decisions and action by Israel, Ireland, Australia and others have converted agricultural economies to ones based on high-growth technology-based businesses. In the United States, a government program of support for venture capital investment fueled an explosive growth in new business formation in the 1960s, and has continued to make a major impact for over forty years.
- ❑ The aim of most government support programs in Western countries is to encourage investment in small enterprises by non-governmental sources. In China, where provincial and local governments provide so much of the available venture capital, a Central government program can, in addition, also encourage sustainable investments and target specific segments of the economy.
- ❑ To attract non-governmental sources of financing, an economy must have laws and regulations that allow the formation and operation of entities that make direct investments. It must be easy for companies to be established, and an investor must see a way to ultimately sell his investment. Furthermore, laws must protect the rights and property of investors, and assure transparent and predictable rules that apply to all. Administration and regulations must be fair and practical, and must not delay business activities.
- ❑ Technology-based businesses need an educated workforce, with well trained business and scientific management. Education is therefore a key. Similarly, new enterprise development is most prolific in countries that have a culture of entrepreneurship that rewards and appreciates success while forgiving failure when it is a result of an honest creative intent. China is strong in both education and entrepreneurship, and this should be recognized as a major strength.
- ❑ Even in countries like the United States, Australia, Ireland and Israel, in order to attract non-governmental sources of venture capital investment, programs have been heavily promoted by well-known leading citizens, both inside government and in the private sector.

Competing Objectives of Economic Development and Sustainability

The ideal program of government support is one that encourages investment by non-governmental sources, and results in an investment program that can be self-sustaining without continuing investment by government.

There are two main reasons why investors and governments invest in SMEs: profits and economic development. Private investors seek the highest rate of profit on their investment, consistent with the risk they are taking. Governments invest in order to accelerate the development of their economies.

In the Western model, government programs are designed to take advantage of these competing objectives. Government offers incentives that increase the potential profit to the private investors, or reduce their risk of loss. In return, the investors agree to invest in sectors of the economy that are targeted by government as being particularly important to economic development. Sometimes the government support is available only to high-tech companies; sometimes to all companies that are new or very small; or sometimes to companies in a specified geographic region.

In China, there is a special challenge, since local and provincial governments are the primary investors, and they are mostly interested in economic development, rather than in making a profit from their investment. One risk is that investments will be made that have a short term benefit of creating jobs or developing new products or markets, but which do not generate enough cash flow to allow them to be self-sustaining over a long period of time. Another risk is that investments will be made without regard for how they will eventually be sold. In either case, the investment program will not generate cash to sustain its operations, and the government will have to keep investing new money into old investments.

The same situation has been faced by investment funds sponsored by international development agencies, as well as by individual states in the United States, and by community development venture capital funds sponsored by individual cities in the U.S. These have operated for many years, with a focus on economic development rather than investment returns. The primary lesson they have learned is that is essential to bring into the activity a party that is motivated by the need for profitability and turnover of investments.

Specifically, all of these financing agencies have stopped trying to invest directly, and have placed the government-supported investment funds in the hands of investment managers who receive a portion of the profits from investments that have increased in value, and have been sold. Their motivation is then to invest in companies that can make a profit, and to sell these investments. This makes money for the manager while generating cash that can be used for new investments. At the same time, government satisfies its objective of economic development by restricting the funds' investments to sectors of the economy that government wants to support.

Selection and Training of Investment Managers

The success of any investment program is based on the ability and experience of the persons managing the process. A venture capitalist ideally should know how to evaluate and structure investments, and how to assist the management of companies in the development of their business. Throughout the world, the training of investment

managers is still based on actual experience, working under the guidance of an experienced investor until the person is able to operate independently. This type of training is much more available in markets that have many venture capital funds, and many opportunities for experience over a period of years.

China is accelerating the process of developing a venture capital industry, yet it has relatively few established investment funds offering this kind of experience. To some extent, it can look to returning citizens who have had experience in the venture capital industry of another country. For the most part, however, Chinese venture capitalists will be trained in China. The development of training materials and the offering of training courses is therefore of critical importance to the rapid development of the venture capital industry here.

Importance of a Supportive Legal and Regulatory Framework

Successful growth and development of a domestic venture capital industry in China will require a much more friendly and supportive legal and regulatory environment than that which exists today. Non-governmental investors in particular face severe problems in three areas:

First, it is difficult to impossible to organize a venture capital investment fund that has the flexibility that is commonplace in other countries. Almost all venture capital firms in the West are organized as limited partnerships, which are not provided for in Chinese law, and there is no relaxation of protective rules for substantial and sophisticated investors who are able to take care of themselves

Second, under existing law it is difficult to structure and value investments. Minimum capitalization requirements, rules on the valuation of intangible assets, and the limitation of issuance of different classes of stock are some of the barriers faced by the investor

Third, there are severe limitations on an investor's ability to sell or exit an investment: lockup requirements of Initial Public Offerings are much more restrictive than in other countries, while repurchase and cancellation of shares by a company is subject to the consent of other shareholders and creditors. Experienced venture investors consider exit strategies as a critical element of their investment decisions.

Forms of Government Support

Governments can increase availability of venture capital, either by investing public funds or by making it more attractive for non-governmental sources to invest in these companies. The objective of investors is to generate the highest risk-adjusted rate of return on their capital. Consequently, government can attract private capital either by increasing the potential rate of return to investors in a venture fund, or by reducing the investor's risk of loss. Specific plans range from:

1. Direct participation, or “seeding” of venture funds, as France provides for investors in younger companies. Government invests on the same basis as private investors, thus increasing the size of the fund and allowing greater diversification of its investments. A variation is the German plan of co-investment with venture funds.
2. Tax credits, as Canada has offered, as a direct offset of a percentage of the investor’s capital investment, so long as the fund invested in the target sectors of the economy. Alternatively, governments have offered a reduction in tax liability on profits earned from investments in SMEs.
3. Government Loans or loan guarantees to licensed venture funds that would invest within government guidelines, or guarantees of fund borrowings. The U.S. Small Business Investment Company program (SBIC) and the program of the U.S. Overseas Private Investment Corporation (OPIC) use this kind of support, offering loans or loan guarantees in an amount of twice the private capital of the fund. Since the interest rate on the government debt is well below the profit expectations of a venture fund, the excess returns flow to the private investors, increasing, or “leveraging” their potential rate of return.
4. Leveraged equity participation by government in private equity funds. This practice has been offered as an option by the U.S. SBIC program since 1994, and by the Australian Innovation Investment Program. Government provides two thirds of the capital of a venture fund, but takes only a government interest rate plus 10% of the fund’s profits. Any excess profits flow to the equity investors who have provided only a third of the fund’s capital. This again enhances, or “leverages” the profit potential to the private investor.

A particularly successful variation was the Israeli Yozma fund, which invested in the early Israeli venture capital funds ten years ago. Investing 40% of the total, the Israeli government agreed that the funds could repurchase the government share within a five year period, at cost plus a nominal interest rate. This again provided "leverage" for the private investors, without subjecting them to the risk of an obligation that would take precedence over their own investment in the fund.

5. Governments have provided guarantees against loss for investors as a way of encouraging them to invest in venture funds. For example, the U.S. State of Oklahoma guarantees investments in state-sponsored seed and early stage investment funds. Austria offers a similar guaranty to investors in SMEs.

Effectiveness of Government Support

Evidence of the effectiveness of government support comes from the experience of the U.S. SBIC program, which is the largest and oldest government support program in the world. When the program started in 1959, the U.S. venture capital “industry”

consisted of about 15 funds, with a total of no more than \$500 million to invest. The program multiplied the availability of risk equity. The ready availability of financing led to an explosive growth in the formation of new enterprises in this country. Later adoption of new laws allowing investment in venture firms by pension funds and insurance companies brought the total to another new level.

The SBIC program is particularly important in providing an opportunity for young fund managers to raise their first venture funds. With government providing two thirds of the capital, a \$30 million fund requires only \$10 million of equity. With the profit enhancement of the government leverage, it is possible to raise this size pool, whereas without the leverage most managers could not raise the \$30 to \$100 million required to form a first fund with purely private capital. Most of the outstanding private U.S. venture funds have their roots in the SBIC program many years ago, and the successful SBIC managers of today will be the great venture investors of tomorrow.

A principal objective of the SBIC program is to provide a source of capital for smaller, younger businesses in a wide range of industries. The investment restrictions of the program support this objective. The statistics confirm the success of the program: In the year 2000, over \$5 billion was invested by SBICs, in 3,000 separate investments, of which 2,250 were first investments in companies. While less than 10% of the dollar value of all venture investments, the SBICs represented over half of the number of all individual investments by organized venture capital funds in the United States.

Of the first-time investments, half were in companies less than one year old, and 70% were in companies less than three years old. Of all equity investments:

- 64% was invested in a broad range of non-high-tech businesses (vs. 3% for the private firms)
- Median investment was \$900,000 (vs over \$5 million for the private firms). This is large enough to finance the growth of a small business, but above the amount typically available from the founder and his friends and family.
- Investments were made in 47 of the 50 states in the United States.

Government Support in China

The government of China has stimulated a remarkable beginning of a venture capital industry to support new and growing high-tech businesses. The next step is to develop an infrastructure for effective operation of this industry, and to attract non-governmental sources of investment. This will require the following:

1. Enactment of supportive laws and regulations regarding:
 - a. Organization and operation of investment funds
 - b. Formation and capitalization of non-governmental corporations
 - c. Transferability or repurchase of shares, as required to exit investments

2. Easing of restrictions on investment in venture funds by institutions such as insurance companies, and by substantial and sophisticated investors who can accept the risks of long term unmarketable investments
3. Encouragement of delegation of investment operations to independent fund management companies that are compensated by a participation in realized profits from their investments.
4. Development of training materials and courses for developing venture investors.
5. Direct government support to venture funds through a program similar to the U.S. SBIC program, targeted at sectors of particular importance to the government.

Recommended Pilot Program

To test whether a government support program in China would attract non-government sources of equity financing, we recommend a pilot program, managed by SETC, in which the government would agree to loan or guarantee loans to privately managed investment funds. As a pilot, we recommend support for five investment funds, each with a minimum of at least 100 million RMB, including both equity and loans from the government.

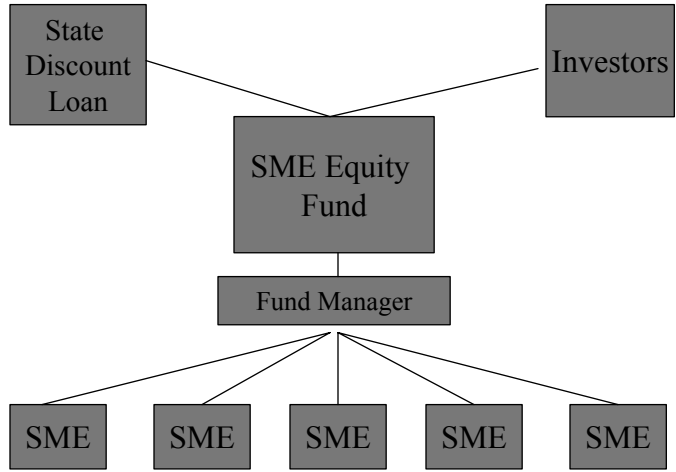
To encourage non-governmental investment in the funds, government would loan or guarantee two times the non-governmental investment in the funds, but only one times government investment. Loans would be made at government interest rates, and would be repayable at the end of a ten year life of the funds. To avoid the need for current payment of interest by investment fund, loans would be made on a discount basis, i.e. with interest payable at the end of the term of the loan.

Proposals for the funds would be solicited from fund managers, who would be responsible for raising the equity investment in the fund. The first and most important determination to be made by SETC is whether the fund manager has the ability and experience required to manage the proposed fund. The second consideration would be the manager's ability to raise the required equity for the fund, and the types of companies in which the manager proposes to invest.

Depending on the desires of the investors, the manager could propose either to have SETC guarantee loans that would be provided by banks or other lenders, or to guarantee loans to be made by the same investors that are providing the equity for the fund. Since the loans would provide only a government interest rate, the first of these strategies would allow any profit from investments above the interest paid on the debt to flow to the equity investors, thus increasing their rate of return. In the second strategy, the equity investors would have the safety of knowing that up to two thirds of their investment was guaranteed, both as to repayment of principal and interest.

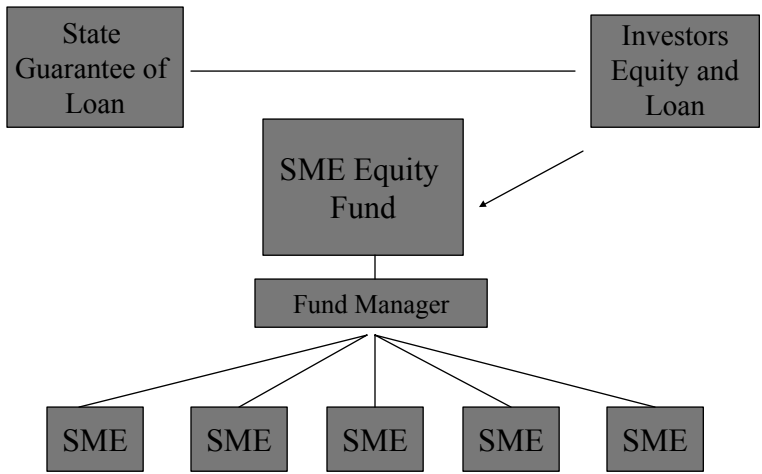
The first program, to increase returns to investors, would be as diagrammed below:

Structure of the SME Equity Program



The second strategy, to reduce risk to the investors, would look like this:

SME Equity Program for Reduced Risk



We have proposed detailed regulations for such a pilot program, based on the Australian Innovation Investment Program, which in turn was based on the U.S. Small Business Investment Company program. Importantly, the funds would be allowed only to invest directly in SMEs. Investors would be allowed to make commitments to invest, but to actually invest in the funds only when money was needed for investments. This avoids having investment money tied up at low interest awaiting investment. It also removes the temptation to make open-market investments with excess cash in the fund. International best practice never allows mixing of open market investing in the same fund that is making direct equity investments.

To widen the sources of investment for these funds, we recommend that the following institutions and individuals be allowed to invest:

1. Municipal and provincial governments
2. Large companies
3. Pension funds
4. Banks and insurance companies
5. Foreign investors, and
6. Wealthy individuals

Given the benefit of the “leverage” provided by the government loans, the equity investors could expect to achieve an acceptable profit return while promoting other objectives, such as economic development, improved relations with government, development of new supply sources, alliances in other industries, or learning about other industry sectors.

Summary

In summary, high growth companies are important to China, whether based on technology or operating in traditional fields. Equity financing is required to promote the growth of these companies. It will be important to encourage investment by non-governmental sources. As other governments have found, this will require a support program to increase potential investor profits or reduce their risk of loss. We have recommended a pilot program, to be administered by SETC, to demonstrate the effect of such a support program.