


Appendix Z

Government Support for SME Equity Financing International Best Practices



**Government Support for SME
Equity Financing**
International Best Practice
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Objectives

- To increase availability of equity for SMEs by attracting non-governmental sources
- To target investments in high-growth, high potential businesses
- To create investment funds that will be profitable and self-sustaining.
- To provide experience to investors and fund managers

Why is Government Support Needed?

- Investing is a truly global business, so an investment in China must compete with all other investment possibilities
- Investors seek the highest risk-adjusted rate of profit on their investment
- SME investments are risky and take a long time to mature
- These investments are unmarketable

Aims of Government Support

- Government programs change the risk-adjusted potential profit by:
 - Increasing the profit to the investors, or
 - Reducing their risk of loss

What Can Government Do?

To provide additional venture capital
Government can either:

- invest its own money in venture capital investments (directly or through funds), or
- Support public-private partnerships to encourage private investment

Tools of Government Support

- Government increases return or reduces risk
- Direct participation in investment funds
- Tax credits
- Loans or loan guarantees to investment funds
- Leveraged equity participation
- Guarantees against loss

Public-Private Partnerships

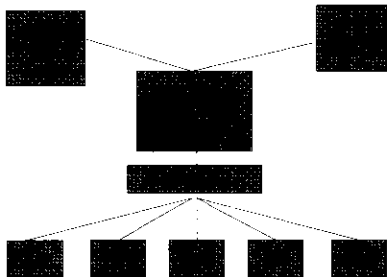
The oldest, largest, and most successful support programs, including U.S., Israel, and Australia, are partnerships between:

- Government
- Private Investors
- Private Fund Managers

Role of Each Partner

- Government targets size or sector of investment, and agrees to take low rate of return on its participation
- Private investors invest with potential for increased rate of return or reduced risk
- Private managers invest professionally, with motivation of carried interest in fund profits

Structure of the SME Equity Program



Some Examples

- Israel Yozma Funds:
 - Government put up 40%
 - Private Investors put up 60%
 - Private Fund Managers
 - During first 5 years, Private Investors Could Purchase Govt investment at cost plus government-rate interest

Some Examples (2)

- Australian Innovation Investment Funds
 - Government invests 2/3 of Fund Capital
 - Private Investors invest 1/3
 - Private Fund Managers
 - Cash distributions to govt and private investors in proportion to investment, until all investment repaid with govt-rate interest
 - Thereafter, govt takes only 10% of profit distributions

U.S. SBIC Program

- SBIC Program active since 1959
- Government provides 2/3 of capital, private investors 1/3
- Government seeks only a low return
- Privately managed
- Two programs:
 - Debenture Financing
 - Equity (“Participating Security”)

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U.S. SBIC Program (2)

- Over \$5 billion invested by SBICs in 2000
- Nearly half of all investments by organized venture capital organizations in the U.S.

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Recommended Pilot Program

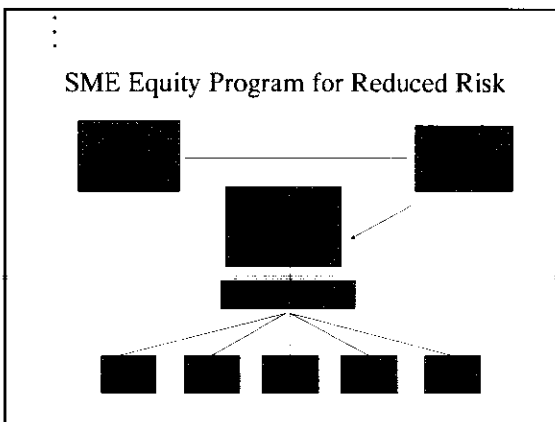
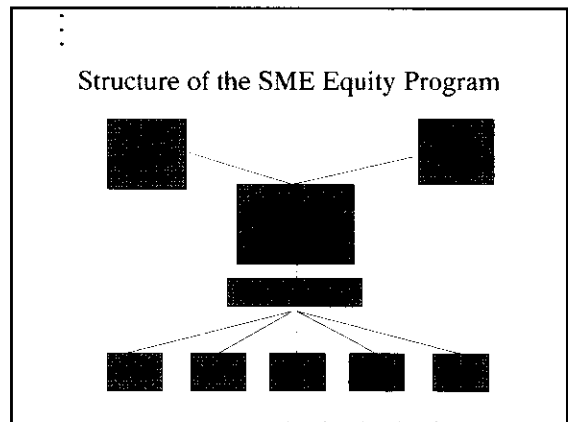
To test whether a government support program would attract non-government sources of equity, we recommend:

- Government to offer discount loans to five new investment funds:
 - Loans two times non-government investment
 - One times government investment

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Pilot Program (Continued)

- Regulations based on the Australian and American programs
- Investments must be direct into SMEs, either high-tech or traditional
- Program administered by SETC
- Government loans from the Development Fund proposed in new legislation
- Government to loan or guarantee loans



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Potential Investors

- Municipal and Provincial Governments
- Large companies
- Pension funds
- Banks and insurance companies
- Foreign investors
- Wealthy individuals

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Reasons for Investment

- Achieving acceptable profit return while promoting other objectives, such as
- Economic development
- Improved relations with government
- New supply sources
- Alliances in other industries
- Market information on other sectors

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Summary

- Both traditional and high-tech SMEs are important to the growth of China
- Equity financing is required
- To attract non-governmental sources of equity, a government support program is needed
- A pilot program will test whether support based on the Australian/US model will work for China