

# Options for delivering risk capital to innovative enterprises in Belarus

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in consultation with the Task force on with the Task force on public-private venture funds  
supporting innovative projects in Belarus*

## Overview

This note presents options for facilitating equity type investments in innovative enterprises in Belarus. The options are a “co-investment” model, an “equity carry” model, and a “fund-of-funds” model. The three models selected have many elements in common but differ in terms of their reliance on particular contractual arrangements, funding instruments and vehicles, and, in some cases, exit mechanisms. They also differ in terms of overall complexity, with the fund-of-funds option being relatively more complex than the other two models.

Each model is designed in view of the fact that risk and growth are closely intertwined for young innovative businesses. Seed and early stage ventures typically need some time before they are on a sustainable (*i.e.* profitable) path. Thus, they require a longer-term investment horizon. The problem is that many firms fail in the attempt to commercialize new innovations and lose all the funds investors give them.

Negative cash flows, untried business models and high uncertainty explain the reluctance of traditional providers of finance to invest in the early stages of innovation. Often, a so-called “missing markets” problem emerges whereby a lack of finance results in some of the innovations associated with young start-up firms never becoming commercialized. The unanswered question is at what cost.

Innovative SMEs are often engaged in sectors that, while risky and volatile (e.g., information technologies, business services and scientific R&D), typically have large payoffs when successful. Among the benefits of successful ventures of this nature are increases in productivity and higher aggregate job creation rates than other sectors.

Most SMEs are basically subsistence driven. They start small and remain small. Among SMEs, the proportion of enterprises that do grow is generally quite small – only about 4% on average of all micro start-ups. But this tiny subset creates a disproportionate number of new jobs. In fact, the rapid scaling up of a small number of very successful start-ups is one of the main drivers of aggregate employment growth in many countries. The economic dynamism of countries at various levels of development is highly dependent on these outcomes. Hence, whatever each country’s success in financing SMEs in general, there is a need in the continuum of financing vehicles for specific financing alternatives for companies that have high growth prospects, but also have very high risk.

Given the importance of these enterprises for economic growth, many countries have endeavored to develop and implement policies aimed at fostering entrepreneurship and removing barriers to the development of risk capital markets. These policies generally exist alongside the much broader efforts to expand the access of all smaller enterprises to financing. In addition to financial assistance measures (*i.e.* loans, guarantees, equity participations, etc.), the broader framework of government support for the SME sector also addresses infrastructure issues such as the business environment for SMEs, as well as building SME capabilities and promoting access to markets.

The three models presented in this note should be seen as complements to these other measures. Providing adequate finance to SMEs requires a broad range of financial products

and services appropriate for the firm’s individual circumstances. Each stage of development requires its own blend of financing vehicles (Table 1), with investment at any given stage of the life cycle being contingent on perceptions of the firm’s potential to advance to the next stage and on various environmental factors. They include factors that can support innovative activities by encouraging individuals and institutions to invest or impede them by creating disincentives to entrepreneurship and investment of risk capital.

**Table 1. Funding Arrangements for Innovative SMEs**

<b>STAGE OF FIRM’S LIFE CYCLE</b>	<b>SOURCES OF RISK CAPITAL</b>	<b>SUPPORTING FACTORS</b>
<b>Seed</b>	Personal Assets Family & Friends Individual Investors Academic & Professional Colleagues Government & University Grants Endowments and Foundations Seed Funds	Supportive environment for Entrepreneurship Business/Government/Research Links Government & University Support for Applied Research
<b>Start-Up</b>	Family & Friends Individual Investors Academic & Professional Colleagues Government & University Grants Business Angels Venture Capital Endowments and Foundations	Robust Legal System Enforceability of Contracts Efficient Bankruptcy Regime Support Facilities Science Parks/Incubators Favorable Tax Environment Business Angel Networks
<b>Expansion</b>	Business Angels Venture Capital/Private Equity/Mezzanine Finance Pension Funds Endowments and Foundations Corporate Venturing Government Foreign Venture Capital	Institutional Savings Sufficient Volume Flexible Regulation Legal Framework Tax Transparency
<b>Exit</b>	IPO Institutional Investors Retail Investors Trade Sale Strategic Investors (M&A) Private Equity	“Growth” Exchanges/Second Tier Environment for M&As

Source: OECD

Many different policy instruments for supporting innovative activities have been used. Among the more common measures are:

- guarantee schemes for debt finance for start-ups and very young businesses
- early stage equity for innovative firms with perceived high growth prospects
- innovation vouchers
- grants and subsidies
- tax incentives

While many measures address the access to finance question, it is important to note that the failure of small firms to find suitable funding alternatives does not necessarily mean that the alternatives don’t exist. It can be the case that the owner/managers of the firms in question

do not know where to look for alternate sources of finance or don't know how to articulate a business plan that meets the requirements of prospective lenders or investors.

As a consequence, countries with a lot of success in supporting the provision of risk capital to innovative enterprises take a coordinated approach to the issue. For example, the United States has, in addition to the common support measures mentioned above, an established ecosystem of start-ups, incubators, angel investors, and venture capital firms. The ecosystem covers both the demand and supply sides of the market. The success of the approach, which has been adapted in other jurisdictions, is one indication that an appropriate framework can be devised in which funds can be provided to innovative SMEs at reasonable cost and at acceptable risk-adjusted rates of return for investors.

Having an integrated approach to supporting risk capital for innovative firms, with a lead agency to coordinate, is a good practice that is reflected in the suggestions in this note. Various agencies may participate in different aspects of a risk capital program, but there is need for a lead agency to manage the program effectively. However, for the specific purposes of identifying options for venture capital funds, the note draws on practices in a range of other jurisdictions, including Australia, Israel, Tunisia, and the United Kingdom.

### Options for venture capital funds

The success of venture capital at the fund level depends on finding opportunities for investment projects with high growth potential within the target market (e.g., national, regional, or sector). The venture capital process works best when an informal capital market generates a large flow of companies seeking expansion and options exist for successful exit. The existence of accelerators, incubators, and business angel networks can play an important role in this regard. For example, business angels serve as mentors to target entrepreneurs and as sources of market information, business advice, and finance. Their activities are widely seen as helping to improve the competitiveness and commercial viability of emerging and fast-growing small businesses.

Hence, while the three models presented below focus on venture capital financing, they benefit from the various forms of capacity building. It is important to note at the outset that the proper design and implementation of each of the three options requires certain prerequisites to be met in order to determine the proper focus, size, and scale of the intervention and the level of public support needed. In particular, the design specifications and parameters of the fund models should be based on a systematic assessment of the scale and specific features of the demand and supply sides of the risk capital market in Belarus.

Against this backdrop, each option discussed below is presented alongside other policy instruments, which are important complements to the equity fund schemes. Such a combination of instruments is needed to meet the needs of innovative businesses at many different stages of development and with different preferences regarding the form of financing desired.

As presented in this note, all three options are generalist in nature, meaning they are capable of addressing any given sector or technology. It is a matter of choice whether or not particular

sectors are selected. The target enterprise population is another choice variable. The types of small enterprises most often targeted in risk capital programs around the world include innovative firms at the start-up, initial growth, and expansion phases of development, such as *de novo* start-ups, university spinouts, and small young enterprises seeking capital for expansion. However, the precise nature of the target population in other countries does vary according to local preferences, and the models presented in this note do not preclude the adoption of particular target populations in Belarus. Multiple targets are possible, as are specific technologies or sectors.

#### A. Equity Carry (Portage) Model

Figure 1 illustrates the main components of the equity carry or “portage” model. The concept of “carry” is similar in some respects to repurchase agreements, in which participants sell securities and simultaneously enter into an agreement to repurchase them after a specified time at a given price. The price typically includes interest at an agreed-upon rate. Equity carry agreements feature many of these same characteristics, except that the underlying securities are not money market instruments or other fixed-income government notes and bonds. They are common shares or other equity interests in private companies.

Similar to the practice with repurchase agreements, the acquirer of the securities in a carry arrangement is entitled to all benefits accruing to the securities during the holding period. In exchange, the acquirer also bears the full equity risks. This latter feature helps explain the usefulness of equity carry agreements. They can be used to transfer the risks of an early-stage equity investment during the initial financing rounds, which normally carry higher risk as the performance of the invested companies is still untested. With this objective in mind, governments can use public funds to encourage private investment in innovative SMEs, by covering a share of the initial capital need of these ventures.

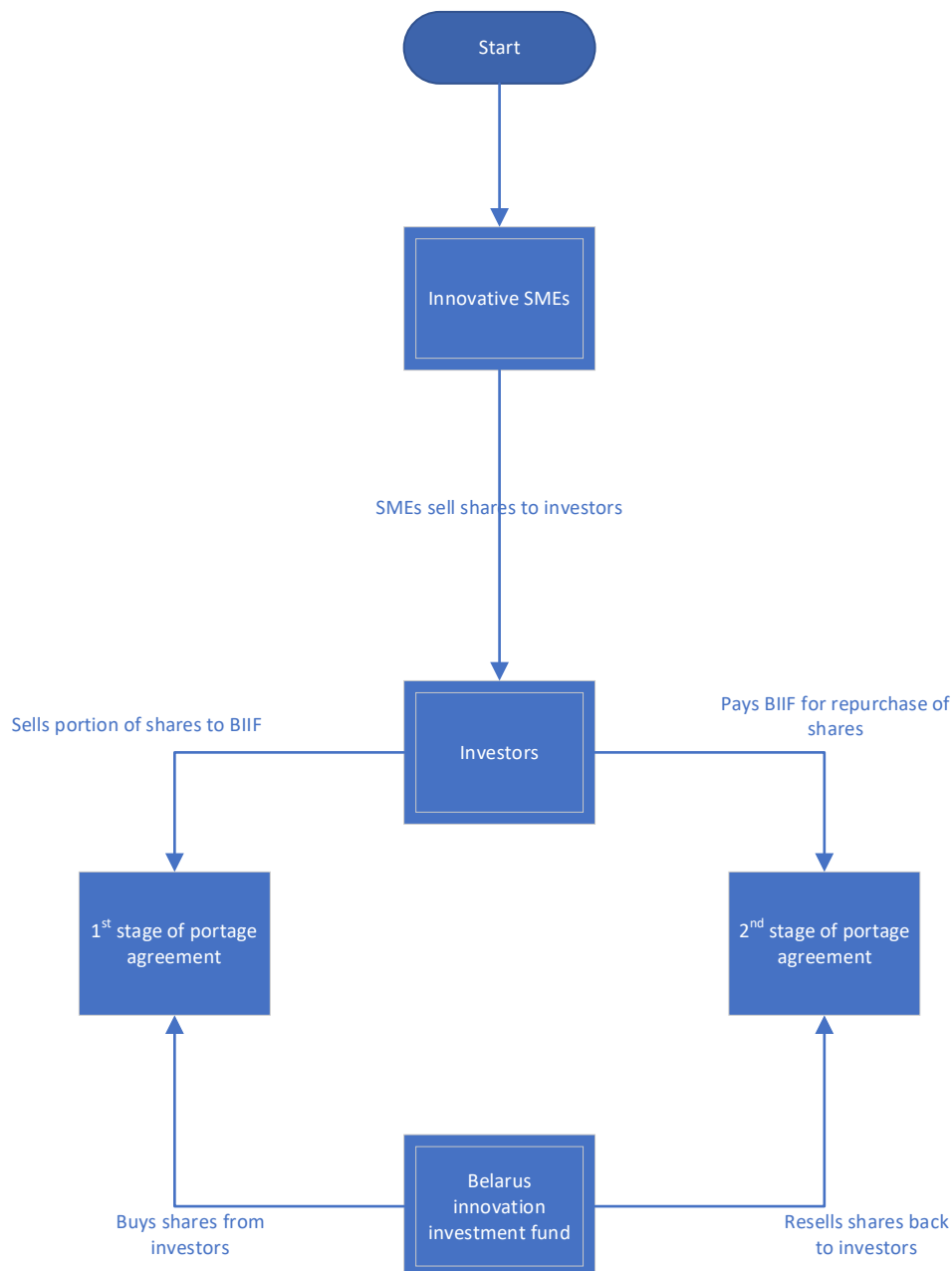
The public sector contribution can be made in a number of ways, such as via dedicated agencies. The model presented herein relies on the use of public-backed investment fund. The “Belarus Innovation Investment Facility” (BIIF) would be entirely financed by public funds and would be registered in Belarus according to domestic law. The BIIF will acquire minority equity participations in innovative companies that meet the requirements of the targeted enterprise population. The investments will be made only in parallel with equity investments made in the same companies by qualified investors (domestic or foreign).

As opposed to a state-controlled investment process, the investment process would be driven by the private investors, who would be responsible for most of the specified tasks (e.g. legal, financial due diligence, etc.) and would bear the associated costs. Given these requirements, business angels, venture capital firms or other professional fund managers would be the most logical counterparts. These sorts of investors would have the necessary skills to perform valuations and negotiate terms of the equity issue with the target company owners.

As part of the process, the private investors would enter into an agreement with the BIIF to sell a portion of the new equity shares acquired to the fund at the issue price. The BIIF would hold the shares for a pre-defined (carry) period and bear the equity risk. At the end of the agreed holding period, the BIIF would re-sell the shares in question to the private investors at

a pre-specified price, determined by the agreed annual interest cost of the carry. The private investors would be free to choose how to handle the re-acquired shares, such as holding them to the point of exit or attempting to dispose of them beforehand.

Figure 1 Equity carry (Portage) model



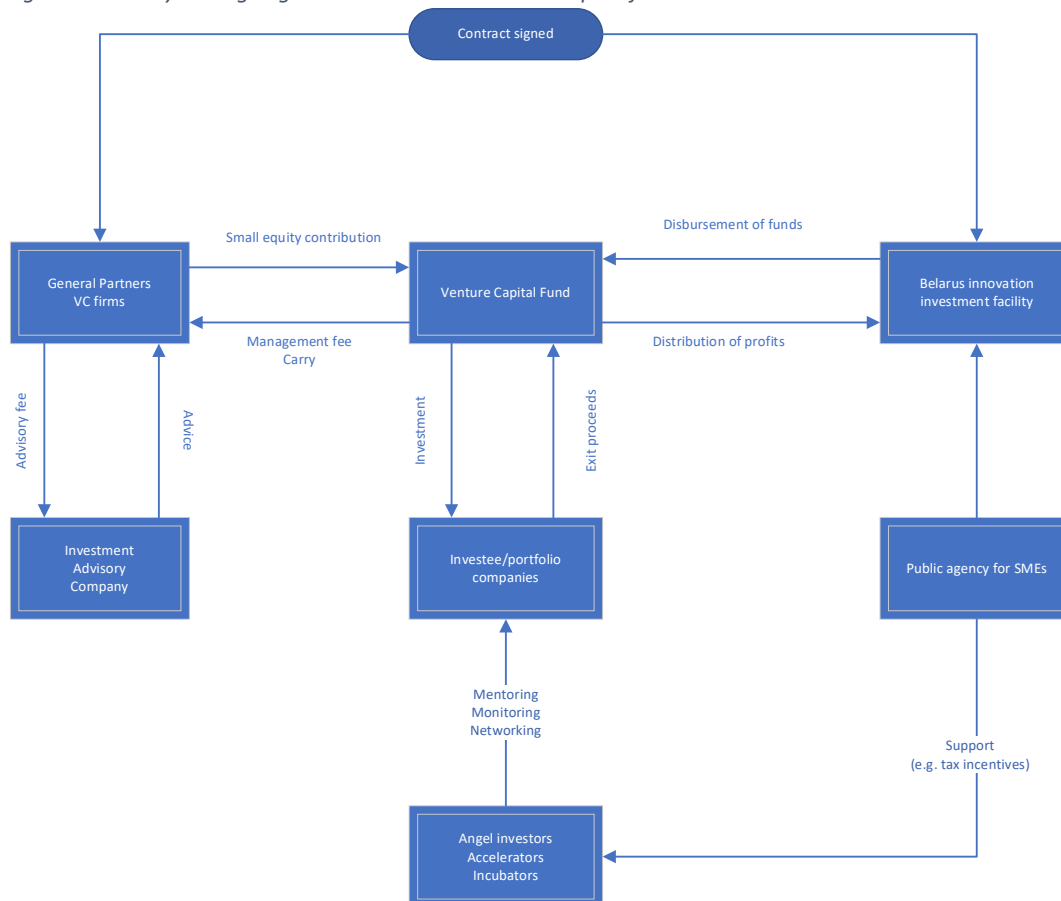
In effect, the carry arrangements enable the private investors to convert a portion of their equity risk to a fixed-rate loan, freeing up capital in the interim. By lowering the risk borne by the private sector investors, the arrangement is intended to encourage more investors to participate in financing such risky ventures, which should help boost the scale of the domestic venture capital market.

## B. Co-investment Models

Figures 2 and 3 illustrate the co-investment fund approach. In the present context, co-investment entails joint investment in target companies by public and private sector participants. As with the carry model discussed above, the public sector contribution can be made in a number of ways: directly via dedicated agencies or indirectly via a public sector fund or as a co-limited partner with private sector investors in an independent venture capital fund. Direct investment in target companies by public sector entities has become less popular, in favor of arrangements that draw on the skills of professional fund managers.

The prevalent view these days among economists and many policymakers is that the role of public support in establishing venture capital funds is not to take the place of private investors and fund managers, but to provide the initial funds and to introduce a set of incentives that will stimulate private investment. By co-investing with private investors in a hybrid fund, the government's interests are *de facto* aligned with that of the private investors and may send a signal to private investors that the fund in question will operate with commercial objectives and strategies that seek to maximize returns.

Figure 2 Privately managed government-backed venture capital fund



a) Privately managed government-backed venture capital fund

A prime example is a hybrid public-private fund, which is established by the public sector, but is operated by private sector professional fund managers. Public investment funds have been used by many governments around the globe to fill a financing gap in the market for risk

capital. They have focused on the seed and early stages of development, when the returns are minimal at best and likely negative and the risks of failure are high. Many investments have targeted start-ups and young companies in the new production frontier, in areas such as nanotechnology, biotech and health care to name a few.

The idea of government venture capital funds is not to supplant private sources of risk capital, but to operate in the less covered high-risk early stage, alongside the few early-stage private investors. A common government objective is to help jump-start entrepreneurial activity. To this end many governments use a range of financing instruments, including guarantees and loans in addition to equity forms of capital. A long-term commitment is usually necessary to achieve positive results, but where equity capital is to be used, the intent is not for the government to be a monopolistic supplier or to obtain control of the venture. The fear of expropriation leads to reluctance on the part of entrepreneurs to accept the government as an investor.

It is important to recall that the scarcity of risk capital in the seed stage of firm growth reflects the high degree of risk of failure in this early phase. There are many examples of public funds being squandered on unsuccessful ventures. The mandate given to the fund managers must be designed to provide appropriate incentives to meet public objectives while operating with commercial objectives and strategies aimed at maximizing returns. There is a need to establish a proper asset and risk management function to find, assess, and manage opportunities. The fund should have a long investment horizon and avoid pressure for a too-early exit.

Figure 3 illustrates the typical components of a privately managed public venture capital fund.

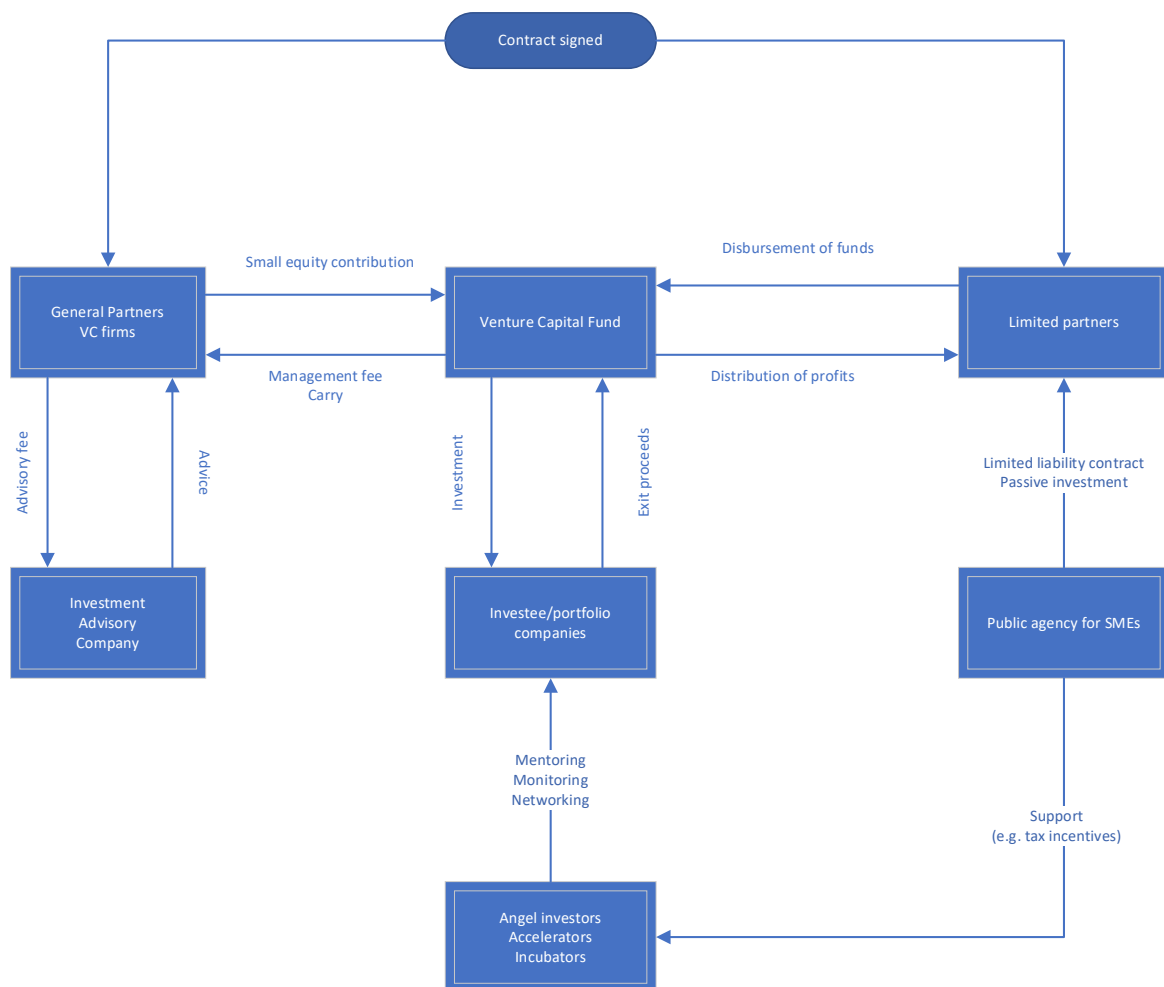
*b) Co-investment in a privately managed venture capital fund*

Figure 3 shows another variant of co-investment. Instead of a government-backed-venture capital fund, this model entails the government participating as a co-limited partner in a private fund. This option seeks to avoid concerns entrepreneurs may have with the government serving as a major investor. For this purpose, the size of the public intervention must be appropriate, which means large enough that it makes a difference, but not so large that it affects the alignment of incentives and objectives leading to relative underperformance of VC-backed firms. A commonly held view is that the public co-investment should not exceed 50% of the total investment amount.

In some of these schemes the share of the government is lower than that of the private investors and most of the “upside” of the investment is transferred to the private investors. Private investors often have the option of acquiring the government’s investment at a favorable rate. These arrangements are designed to draw in private institutional investors as co-investors. To execute the arrangement limited liability partnership agreements are signed between the fund management company on the one side and the relevant public sector body (e.g. the Belarus innovation Investment Facility) and private investors on the other side, who become limited partners in the venture capital fund.

Figure 3 Co-investment in a privately managed venture capital fund





### C) Fund of Funds Model

Figure 4 illustrates a fund-of-funds investment model. It is similar in many respects to the co-investment model, with one major exception. Instead of co-investing in individual companies, the facility established by the public sector (the Belarus Innovation Investment Facility) creates a fund vehicle to invest in other privately managed venture capital funds. These funds can be existing domestic private sector venture capital funds. However, in under-developed risk capital markets, new venture capital funds typically need to be developed for this purpose by experienced fund management companies. This step will add some time to the process.

As in the Equity Carry model, the public sector would proceed by establishing the Belarus Innovation Investment Facility, except in this case, the BIIF would operate a fund of funds and would not invest directly. The BIIF would be the recipient agency of public funds intended to facilitate equity investment into small companies with high innovation potential. The scale of the BIIF would be determined in part based on a proper assessment of the demand and supply sides of the risk capital market in Belarus.

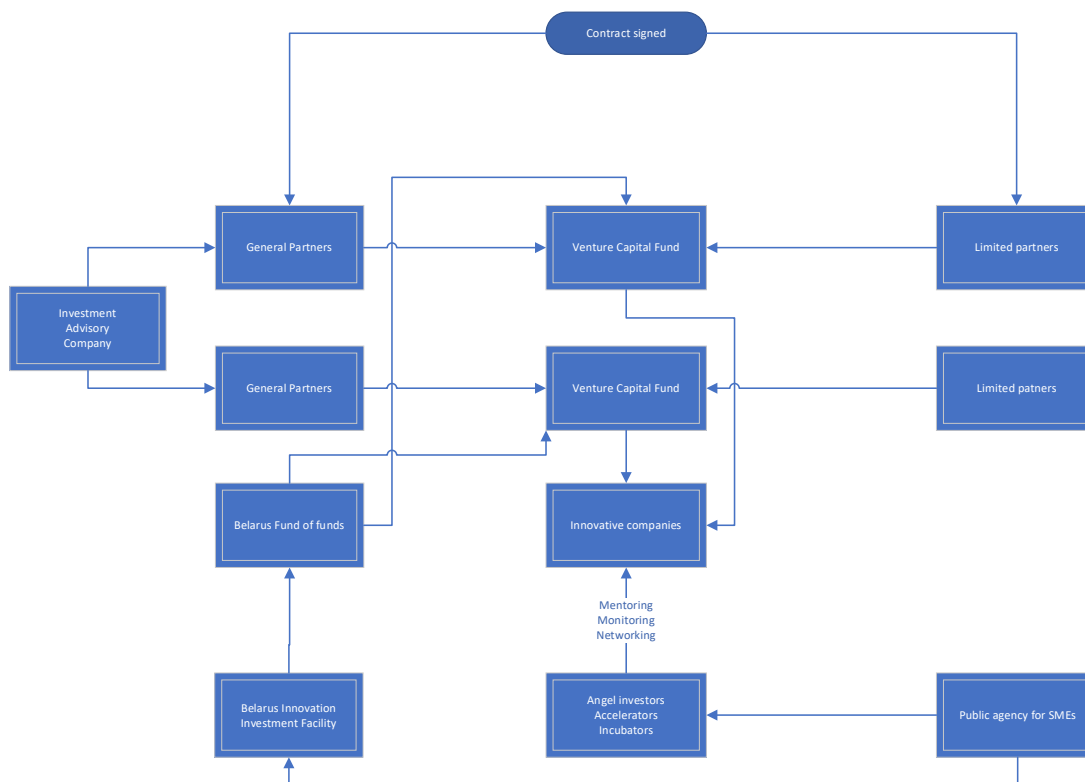
The BIIF acts as recipient of public funds and invests them into privately managed venture capital funds via its fund of funds vehicle. The intent is not for the BIIF to have a monopoly over the provision of equity financing to innovative companies, but instead to crowd-in

private investment. The objective is to build a diversified and competitive VC sector, which calls for providing support to several VC funds.

For this purpose, the BIIF selects private venture capital fund management companies (e.g. through open tender). It is assumed that there will need to be foreign-based fund management companies participating in this process. Winning tenders would be decided based on the management companies' experience and success in venture investing, their access to private institutional investors, their business plans, and their costs and fee structures. Limited liability partnership agreements signed between each fund management company and the lead public sector agency.

Once all the details have been addressed, the venture capital funds can begin to make Investments into individual companies. The amounts invested can take the form of equity or quasi-equity (features of debt and equity, such as convertible loans or debt), but should not be straight debt obligations.

Figure 4 Fund of funds model



### Next steps

After the suitable option is selected, the following steps could be undertaken by the responsible government authority:

- **Step 1** Preparation of a Concept Note to be submitted to the relevant authorities (in this case the SCST) for initial approval. The Concept Note should reflect the consensus reached among the Task Force members.
- **Step 2** Upon approval of the Concept Note, the SCST should commission a detailed feasibility study, including the identification of the eventual changes required in terms

of legislative acts and regulations, a financial and an economic ex-ante evaluation of the project. The feasibility study should be conducted by qualified and independent external consultants and should take into consideration inputs from technology companies and potential investors.

- [Step 4](#) Review and approval of the feasibility study by SCST.
- [Step 5](#) Launch of the process to enact the required legislative and regulatory changes. In parallel, preparation of the standards contractual documents
- [Step 6](#) Negotiations with eventual investment partners, fund managers and operational partners (technological parks, incubators, etc.)
- [Step 7](#) Signing of the contractual agreements and launching of the facility
- [Step 8](#) Building up of the project pipeline.

## Summary

This short note has presents three stylized models for public investment in innovative companies: (i) a contractual arrangement to acquire equity shares from private investors for a fixed period, with a simultaneous agreement to sell them back at a pre-specified price in the future; (ii) a privately managed government-backed venture capital fund that invests on a non-exclusive basis in innovative companies; (iii) public investment as a co-limited partner in a privately managed venture capital fund; and (iv) establishment of a public fund of funds that invests in a number of privately managed venture capital funds. In all four cases, the Belarus Innovation Investment Facility is intended to have multiple operating objectives. They include:

- Attracting private external financing to supplement public and firms' in-house funding
- Expanding capital market support mechanisms for innovative projects
- Attracting foreign institutional investors
- Helping to boost the scale of venture capital funding
- Building a diversified and competitive domestic venture capital sector

The target firms should be small-to medium-sized enterprises (according to local definitions) in the start-up, early-stage, or expansion phase of development. Eligibility may or may not be sector-specific but is focused on potential high-value innovative projects. The projects can include the development of new products or technologies or the expansion of an existing activity to reach commercial scale. The authorities can choose whether to limit eligibility to companies 1) registered in Belarus by Belarus owners, 2) to companies registered in Belarus, regardless of ownership, or 3) to companies with projects aimed at the development of business activity within Belarus, regardless of where they are registered.