8 Financing Innovations

8.1 Sources of Finance for Innovation

Keywords
Financing innovation, business angels, venture capital, public funds, entrepreneurs, founders

After reading the component you will have an idea of what kind of finance is available in order to develop an innovative idea. The component describes the most important sources of finance and remarks on the importance of analysing the stage of the innovation in order to know what kind of financing is most suitable according to the stage and scope of the innovation. It will take about 50 minutes to go through this component.

Introduction
Developing an innovative idea into a product, technology or even a new company is very time and money consuming. An important problem in the managing of innovation is finding the right way of financing it.

Banks may provide loans. Venture capital, also known as risk capital or private equity investment, normally seeks to provide capital through the purchase of shares in the company.

As a rule, a large corporation with an innovative project would be most likely to look to a bank for financing that project. An alternative, for a listed company, i.e., one whose shares are quoted on a Stock Exchange, might be to raise extra capital by issuing new shares.\footnote{This paragraph is taken from Gate2Growth. A guide to financing innovation. European communities 2002}

Another way to finance innovation is by means of strategic alliances\footnote{For more information about Strategic Alliances please have a look to component 11.5 of this guide.} where the companies involved share knowledge, skills and resources as well as expenses.

8.1.1 How to choose the right way to finance your innovation\footnote{The following chapter is based on Gate2Growth. A guide to financing innovation. European Communities 2002}

In general, innovation finance comes from the public sector, banks or from private finance-sources. Which of these is appropriate to a specific case depends on a number of factors: the stage of development of the project, the size of the innovating company, the amount of money required...\footnote{InnoSupport: Supporting innovation in SMEs. 8.1 Financing Innovation in Europe, 2005}
As it has been mentioned above, finance may be available from a number of sources, but before looking at these, some general factors need to be considered. The first point to take into account is: at what stage of development is the project/process/company?

8.1.1.1 Stage of development of the project/process/company\(^5\)

**Research Stage**
Funding will come in the form of non-reimbursable grants from:
- Public sector – national governments, regional authorities or the European Commission
- Corporate – industrial/commercial companies, industrial research associations, charities (when the research is directed to social benefits such as health).

At this stage of the project/process/company neither banks nor any form of equity investor is likely to be interested.

**Development stage**
As the project reaches this stage in which a prototype of pilot plant can be built to demonstrate its viability, the situation changes. The public sector and corporate sector remain as sources of financing but other actors such as seed capital and venture capital may show interest.
- Seed capital – venture funds prepared to make pre-start-up investments in the technology, followed by further investment if/when the project results in a company formation. Pre start-up funding may be in the form of loans, convertible to equity when/if the company is formed
- Venture capital – may be interested where an established company seeks additional finance for a specific project.

**Start-up stage**
In some aspects this is the most difficult stage to finance, though much depends on the size and type of project involved.
- **Business Angels:** may be able to provide the start-up equity finance and “hands on” advice and help to the new company. This source is the most appropriate when

\(^5\) The following chapter is based on Gate2Growth. *A guide to financing innovation.* European Communities 2002
relatively small sums are needed and where the project in question is not in the high technology area.

- **Venture capital (VC):** although most venture funds concentrate on large deals, there are some willing to provide start-up finance. Usually venture capitalists are very experienced and able to contribute management assistance.

- **Public sector:** can provide grants or other non-reimbursable finance to cover start-up and capital costs. Public sector venture funds may want to intervene where for example important employment opportunities are seen.

- **Corporate finance** may also be available from industrial or commercial firms looking for a “window” on developments. Such firms are potential buyers of the new company.

**Exploitation stage**

At this stage of a company’s life, when it is in full commercial operation, banks and all kinds of venture funds can be interested. It is also a stage at which the management might wish to consider a stock market flotation as a means of raising additional capital. This would normally be on one of the “new” markets: AIM (Alternative Investment Market), Nouveau Marché, Neuer Markt, etc which do not have such strict regulation as the main stock exchanges.

8.1.1.2 **Players at each stage**

We will now look at the different players at each stage:

**Founders and Entrepreneurs**

Founders and entrepreneurs will have normally put in all the finance that they are able to afford, as well as non-financial contributions, e.g., little or no salary, working from home (no rent) etc. Putting a value on these non-financial contributions (“sweat equity”) can increase their effective shareholding. New investors will expect to see a significant contribution from the founders, since this shows a commitment to the project.

**Friends and family**

They are a “helping hand” rather than a serious investment because on the one hand they generally invest less than 10,000 € and they cannot be relied upon for follow-up finance and on the other hand they do not have useful commercial contacts.

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6 The following chapter is based on Gate2Growth. *A guide to financing innovation*. European Communities 2002
Informal investors or Business Angels

Informal investors or business angels are “individuals of high net worth”, that is to say people having investable assets in excess of US$1 million. The amount of money they usually invest can vary between 15,000 € and 150,000 €. This sum can be increased up to 250,000 € when they co-finance with others.

The projects they are interested in usually cover subjects they understand and take place in the region of the investors or even in their cities.

Venture Capital

Venture Capital seeks investments over 250,000 Euros with high-growth possibilities. It takes a long time to decide but once the decision is taken it is very thorough. Venture Capital support not only gives financial assistance but add value as well.

Banks

The role of banks is to provide the usual bank services such us loans and loan guarantees from a few thousand to millions of Euros. They usually decide fairly quickly whether to support the idea or not.

Public sector

The support of the public sector is by way of grants, awards, investment support schemes and European Investment Fund (loan guarantees and investments in venture funds)

The following figure shows the stages of development of a process/idea/company and the sources of finances that play a main role in each stage.

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8 Figures taken from Gate2Growth. *A guide to financing innovation*. European Communities 2002
9 For further information you can go to [www.insme.org/](http://www.insme.org/)
It can be seen that some sources are more appropriate than others at a certain stage. Entrepreneurs’ own resources and those of friends and family are easy enough to find. Business Angels, although a very important source of money—for early stage investment the total available from them is greater than from the formal venture capital—may be difficult to find. They have their own networks and anyone seeking capital from this source might try financial consultancies, banks and similar sources.

SMEs and other companies or organisations with projects co-financed by the European Commission may be attractive to various sources of capital, including the Business Angel sector (especially where groups of these individuals are prepared to syndicate their finances), but are most likely to appeal to more formal sources.

**8.1.2 Raising finance: banks**

Concerning financing innovation there are two different kinds of banks: investments banks and retail ones.

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10 Figure based on presentation “Financing Innovation: Funding the Phases of Knowledge Transfer” by Mark Coticchia from Case Western Reserve University (Cleveland – Ohio)

11 The following chapter is taken from Gate2Growth. *A guide to financing innovation*. European Communities 2002
• An **investment bank** is a company that acts as a backer or agent and serves as a liaison between an issuer of shares or bonds and the investing public. The investment banker, can be either a manager or a member of an investment banking association, makes direct purchases of new securities from the issuer and distributes them to dealers and investors, profiting from the spread between the purchase price and the selling one. Investment bankers may be involved as advisers or intermediaries when a company decides a stock exchange flotation.

• A **retail bank**, on the other hand, is the type of bank found in all towns, provides general banking services to the general public and to businesses, including loans, savings accounts, financial services etc.

Investment banks are not normally concerned with the earliest stages of development and retail banks provide services to the public in general and give credit to new companies and entrepreneurs.

### 8.1.3 Equity investment: venture capital

Venture capital provides financial support to a company in the form of a participation in its equity or an option to convert a loan to equity. The relatively high risks are compensated by the possibility of high returns. It focuses on industries with high growth potential.

#### 8.1.3.1 Investment stages

It is important to understand that some funds specialise in certain aspects of the investment business and it is hopeless to talk to one which is not focused on your particular type of opportunity. Most important is the stage of development of your project/company. The following outlines the various stages recognised by equity investors:

- **Seed finance or Seed Capital (SC):** finance offered to research, assess and develop the initial conception of a business before it has reached the start-up stage.
- **Start-up:** finance provided to companies for product development and initial marketing before selling their products commercially.
- **Other early stage:** financing to companies that have completed the product development stage and require further funds to begin commercial manufacturing and sales. They will not yet be generating a profit.

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12 The following chapter is based on Gate2Growth. *A guide to financing innovation*. European Communities 2002
• **Expansion (or Development):** financing provided for the growth and expansion of a company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development and/or to provide additional working capital.

• **Mezzanine (Bridge finance):** finance made available to a company in the period of transition from being privately owned to being publicly quoted.

• **Management Buy-out:** finance provided to enable current operating management and investors to acquire an existing product line or business.

• **Management Buy-in:** finance provided to enable a manager or group of managers from outside the company to buy into the company with the support of venture capital investors.

### 8.1.3.2 Venture capitalists\(^\text{13}\)

In a general way, venture capitalists can be divided into three types, each appropriate to a given range of investments. They may specialise in one or several or the above investment stages and they may also concentrate their attention on specific industrial or geographic sectors.

### 8.1.3.3 Business angels (Private investors)\(^\text{14}\)

These are wealthy individuals who are prepared to use their own financial resources to make risk investments based on their own experience and interests. They are often retired senior executives of major enterprises.

Typically, business angels tend to invest locally in business sectors in which they have some experience. Individually, their investments may be quite small (around 50,000 €) but in syndication, considerably larger sums may be available. They make quick decisions.

?? **Please stop and think:** after reading this piece of information about business angels, can you find some pros and cons of this type of investors?

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\(^\text{13}\) For further information you can go to EVCA Yearbook 1997. *The economic impact of venture capital.*

\(^\text{14}\) For further information you can go to [www.eban.org/](http://www.eban.org/)
8.1.3.4 Fund management companies

This is the conventional venture capital sector. The Venture Capital Fund Management Company manages the funds of its investors (shareholders) and returns the profits, after deduction of expenses and fees, to those investors.

Some of these companies manage quite small sums (a few million of Euros) while the biggest of them handle many billions of Euros. All of them have a clear goal for their investments.

Most of these funds have an established period of time, usually ten years, after which the fund is closed and the profits distributed.

8.1.3.5 Public sector funds

These are funded from regional or national sources, sometimes with private money as well and their purpose is often not for profit and their objectives are regional development and job creation. Public sector funds are usually found in less developed areas.

The main principle of every venture capital fund should be the creation of wealth (profit). It may have other focuses, such as the environment or regional development, but unless the policy is to invest in companies capable of producing a sustained growth and therefore a return on the investment, the money will be wasted.

8.1.4 Case Study

The case study presented in this component is a company in the field of recycling and treatment of demolition and construction wastes located in the north of Spain. European, national and regional governments are very concerned about this kind of wastes.

A joint initiative established between a private construction firm and a public society along with assistance from regional government resulted in the birth of this company which is a leader on its field of activity.

To maintain its leading position in the market, the company is involved in a continuous process of innovation to offer its clients a product with the best characteristics fulfilling all the environmental regulations or even improving them. To do so the manager searches the best technologies available in the market and new applications for the products. To carry out these innovations the company has been involved in several successful R&D projects co-funded by European/ national /regional institutions by means of grants and/or soft loans.

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15 This paragraph is taken from Gate2Growth. *A guide to financing innovation*. European Communities 2002

16 This paragraph is based on Gate2Growth. *A guide to financing innovation*. European Communities 2002
We can see from this case study that the foundation of this company was partly financed by the public sector, a regional authority in this case and a private industrial company. New equipments, machinery, etc needed to improve its productive process are co-funded by the public sector.

8.1.5 Summary of key points
There are several sources of finance available for developing an innovative product / process / company. This component provides general information about them but emphasises the importance of analysing the stage of the innovation in order to choose the appropriate source of finance because each source is focused in one or two stages. For early stages of the innovation business angels and public funds are appropriate but for the exploitation stage, banks and new markets are the ones that finance it. Obviously it also depends on the type of innovation and the size of it.

After reading the component you will have an idea of what kind of finance is available in order to develop an innovative idea. The component describes the most important sources of finance and remarks on the importance of analysing the stage of the innovation in order to know what kind of financing is most suitable according to the stage and scope of the innovation.

Bibliography


Gate2Growth. A guide to financing innovation. European Communities 2002


Coticchia, Mark: Financing Innovation: Funding the Phases of Knowledge Transfer. Case Western Reserve University (Cleveland – Ohio).
Funding or financing: is to provide capital (funds), which means money for a project, a person, a business or any other private or public institutions. Those funds can be allocated for either short term or long term purposes.

(Source: http://en.wikipedia.org/wiki/Funding)

Strategic alliance: a formal relationship formed between two or more parties to pursue a set of agreed upon goals or to meet a critical business need while remaining independent organisations.

(Source: http://en.wikipedia.org/wiki/Strategic_alliance)

Risk capital: the money that a person allocates to investing in high-risk securities.

(Source: http://www.investopedia.com/terms/r/riskcapital.asp)

Equity investment: this type of investment generally refers to the buying and holding of shares of stock on a stock market by individuals and funds in anticipation of income from dividends and capital gain as the value of the stock rises.

(Source: http://en.wikipedia.org/wiki/Equity_investment)