New Approaches to SME and Entrepreneurship Financing
Broadening the Range of Instruments
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Chapter 7

Equity finance for SMEs

This chapter describes typologies of equity financing for SMEs, the profile of firms and the business stage that are suited for the different equity instruments, key enabling factors for their development, recent market trends and policies to boost equity investments in new and small companies. The chapter discusses private equity finance, focusing on and comparing venture capital and angel investments, and public equity, in the form of specialised platforms for public listing of SMEs.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Equity finance refers to all financial resources that are provided to firms in return for an ownership interest. Equity investors participate in the entrepreneurial risk, as no security is provided by the investee company, and the investment return is entirely determined by the success of the firm. Investors may sell their shares in the firm, if a market exists, or they may get a share of the proceeds if the firm is sold (OECD, 2009).

The main categories of equity finance are private equity and public equity. Whereas public equity concerns companies that are traded in some form of stock exchange, private equity investors provide capital to unlisted companies. Also, while public equity investors are not generally involved in the management of the company, private equity financiers provide advice or assist the owners or managers in the development of the firm.

There also exist informal sources of equity finance, which include family and friends. Indeed, for start-up companies, the amount of funds raised through these informal channels generally exceeds other venture finance, including in countries with a well-developed equity capital market, such as the US (Mac an Bhaird, 2010).

Equity markets are key for companies that seek long-term corporate investment, to sustain innovation, value creation and growth (OECD, 2013b). Equity financing is especially relevant for companies that have a high risk-return profile, such as new, innovative and high growth firms. Seed and early stage equity finance can boost firm creation and development, whereas other equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented SMEs.

On the other hand, for SMEs, raising equity capital may be significantly more expensive than accessing debt finance. For instance, the process of raising capital through an IPO of common stock is more expensive per share for SMEs than for large firms, due to the fixed costs of due diligence, distribution and securities registration (Berger and Udell, 1998). Also, SMEs often face a problem of under-pricing in capital markets. Beside costs and the burden of complying with regulatory requirements, it is often the case that entrepreneurs themselves are reluctant to approach capital markets due to the loss of control implied by the wider equity ownership (Mac an Bhaird, 2010).

Forms of private equity: venture capital and business angel investing

Private equity financing includes a broad range of external financing instruments, whereby the enterprise obtains funds from private sources in exchange for an ownership stake of the firm. The capital is provided to *private* companies, i.e. companies whose shares are not freely tradable in any public stock market, across the entire life cycle, from seed financing to buyouts (OECD, 2009).

Through private equity, wealthy individuals, investment funds or institutions participate fully in the entrepreneurial risk of the business, as capital is made available without provision of security. Compared to other forms of external finance, the investor accepts more risk and expects a higher return, typically above 25% IRR (internal rate of return) (see Table 6.1).

The investment is open-ended, though equity investors generally provide capital over a medium- to long-term horizon (3-10 years). The objective of investors is to make profit by "exiting" (i.e. selling their shares through an IPO, a trade sale or buyback by the other shareholders) once the firm has increased its share value.

Private equity investments are less volatile than those in the stock market. Trading does not have an impact on the asset class, as assets are held until maturity and valued on the basis of corporate fundamentals rather than depending on market fluctuations. The lower sensitivity to market variations provides investors a form of protection against equity market downturn and enables them to have stable and attractive returns. For instance, in Europe, since 2001, returns in the private equity segment have outperformed those in public equity markets by 9.4%. The 2008-09 financial crisis further widened the gap return between these markets (Idinvest, 2014).

Private equity is divided into two distinct components, namely venture capital, targeted at new and early stage companies, and other private equity, such as growth capital and buyouts, targeted at mature businesses (see Table 7.1).[1] Buyouts, whereby shares are bought from existing shareholders and control of the company is acquired, include a number of specific types of investments, such as management buyouts (MBOs), management buy-ins (MBIs), institutional buyouts (IBOs) and leveraged buyouts (LBOs). In LBOs, which account for the largest proportion of private equity funds, investors and a management team pool their own money, together with borrowed money, to buy the shares in a business from its current owners. Usually, the assets of the company being purchased are put up as collateral for the funds borrowed, and the cash flow of the same company is used to repay the debts. In this way, investors can acquire a company without the need for a large business capital.

Table 7.1. **Private equity by stage**

	Stages	Definition[1]
Venture capital	Pre-seed/Seed	Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase
	Start-up/Other early stage	Financing for product development and initial marketing. Companies have not sold their product commercially and are in the process of being set up.
	Later stage venture	Financing for the expansion of an operating company.
Other Private Equity	Growth	Investment in relatively mature companies that are looking for capital to expand into new markets or restructure operations.
	Buyout	Financing to acquire a company. It may use a significant amount of borrowed money to meet the cost of acquisition.
	Replacement	The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.
	Rescue/Turnaround	Financing made available to an existing business in difficulty, with a view to re-establishing prosperity.

1. *www.evca.eu*.
Source: OECD (2014b).

Private equity firms are usually structured as a limited partnership. The General Partner (unlimited liability) receives capital from Limited Partners (e.g. pension funds, insurance companies, hedge funds, wealthy individuals). For these investors, the key economic incentive is the opportunity to earn a high rate of return on their invested capital through access to a portfolio of investments sourced and managed by an investment team that is expert in the target sectors or geographies of the fund (Naidech, 2011). Contrary to stock markets, private equity is based on the principle that unlisted markets are inefficient,

due to large information asymmetry. To exploit these inefficiencies and gain returns, an in-depth understanding of the opportunities available on the market is needed, based on corporate fundamentals and assessment of growth potential. Thus, private equity managers must have access to detailed data about potential investee companies and conduct in-depth due diligence (Idinvest, 2014). In this regard, for equity investors the skills and reliability of fund managers are critical.

Fund managers are generally rewarded with fee income and a share of other income and capital gains. To further align the interests of investors and fund managers, fund managers must generally invest alongside the investors, on the same terms in any fund (Gilligan and Wright, 2008).

Private equity companies typically focus on high growth potential or under-performing companies that can be transformed and subsequently sold or floated, fostering rapid corporate restructuring (Blundell-Wignall, 2007). In this regard, they differ in strategy, structure and objective compared to other investment funds. In essence, private equity fund managers seek to control the businesses they invest in and to choose an optimum capital structure for their investee companies. To do so, they generally operate with better information and stronger controls and influence over management than funds holding quoted equities. While fund managers do not exercise day-to-day control, they are actively involved in setting and monitoring the implementation of the firm's strategy. To achieve this, the private equity funds forego liquidity in individual investments and take on financial risk in each investment through the use of debt (Gilligan and Wright, 2008). Furthermore, the closed structure of the equity fund prevents fund managers from exiting prematurely and strengthens their long-term engagement with the investee company (EVCA, 2007).[2]

The main providers of equity finance for start-ups and SMEs are family, friends, business angels and venture capitalists. However, interest in upper-tier SME investment by other private equity funders has increased in recent years, as low interest rates have pushed investors to seek yields and diversification within their portfolios.

In 2013, deals under EUR 500 million accounted for over 97% of the Buyout deals carried out in Europe, while 45% of capital raised by European buyout funds was allocated to the mid-market segment, i.e. deals in the range of EUR 250 million-500 million. According to a survey on 450 institutional investors in alternative assets worldwide, conducted by Perquin in 2013, 52% of investors believed that the mid-market segment offers the best investment opportunities. 62% planned allocations to small to mid-market buyouts for the following year, compared to 18% which planned investing in venture capital (Figure 7.1).

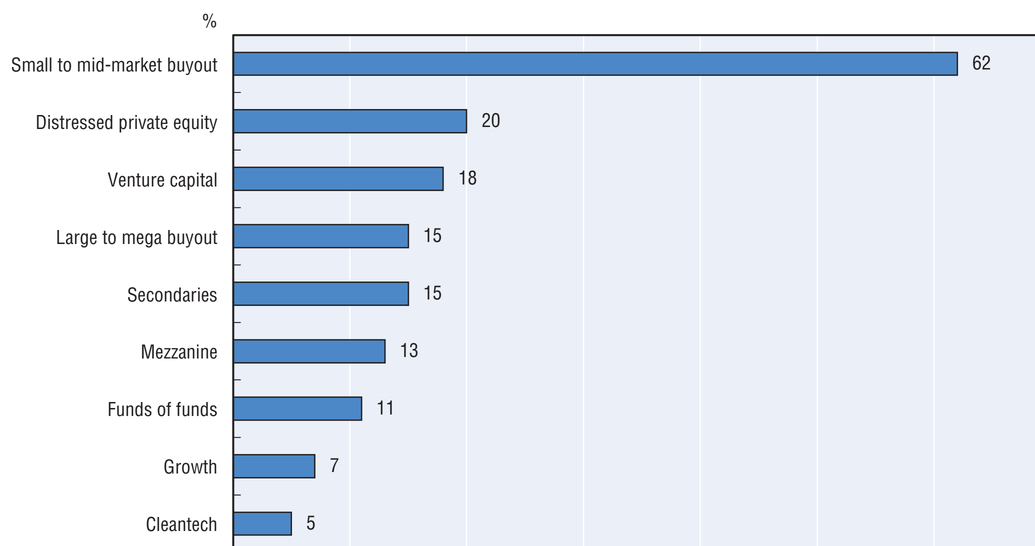
Indeed, as of 2013, small buyouts (less than EUR 250 million) had outperformed larger ones significantly, in terms of return on a 10-year horizon. The outperformance observed has been driven by the growth of the investee companies and by operation improvements. Small and mid-market buyout deals also benefit from low leverage and a higher share in the company's equity, which reduces the risk profile of the investee and increases its potential margins for external growth (Idinvest, 2014).

Venture capital

Modalities

Venture capital (VC) is equity investment aimed at supporting the pre-launch, launch and early-stage development phases of a business (OECD, 2014b). Although it is commonly assumed to be the main source of seed and early stage financing, in fact the majority of venture

Figure 7.1. **Investors' planned allocation to Private Equity for the next 12 months (450 institutional investors worldwide, H2 2013)**



Source: Idinvest (2014) based on Prequin (2013).

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capital firms intervene at a later stage, with a typical investment size of USD 3-5 million, while the seed and early stage market is the main target of "informal" investors, such as business angels (Table 7.2) (OECD, 2011a; OECD, 2013a).

Table 7.2. **Equity investors at the seed, early and later stages of firm growth**

INFORMAL INVESTORS		FORMAL INVESTORS
Founders, friends and family	Angel investors (typical investment size: USD 25-500 K)	Venture capital funds (typical investment size: USD 3-5 M)
Seed stage investments	*Early stage investments*	*Later stage investments*

Source: OECD (2013a).

Indeed, venture capitalists often invest in companies that have already received one or more rounds of angel finance. They typically intervene after a business idea or product has been successfully test-marketed, to finance full-scale marketing and production. Sometimes, however, venture capital may be used to finance product development costs when those costs are substantial, such as for clinical trials in the biotechnology industry (Berger and Udell, 1998).

Venture capital involves "formal" or "professional" equity, in the form of a fund run by General Partners, aimed at investing in early to expansion stages of high growth firms. Typically, venture capital firms raise funds from wealthy individuals, insurance companies, and pension funds, among others. These Limited Partners pay the General Partners to collect management fees (usually 1-2% of the capital committed), which cover the operating costs and enable the fund to hire a group of professionals.

The VC fund's investment portfolio includes various asset classes, such as stocks, bonds and real estate. Venture capital is part of the so-called "alternative investments", a higher risk asset class, from which investors seek to obtain higher returns. Within this asset

class, the equity fund invests in a portfolio of companies, knowing that some will succeed, some will fail and the majority will have average or sub-par performance (OECD, 2013a).

A venture capital fund typically has a 10-year life, at the end of which the partnership dissolves and distributes its assets to the partners. However, an extension may be agreed upon by the Limited Partners, so that some VC funds operate for 15-20 years. Generally, the investments in start-up companies are made throughout the first three/four years of the fund, with follow-on investments in portfolio companies being carried out for another few years. In fact, for early stage projects, venture capital typically involves the provision of several rounds of finance rather than a one-off injection of funds. The VC funds need a sufficient scale to be able to provide multiple financing rounds. At about the middle of the fund's life, when some early harvesting of the first successful businesses may have occurred, the General Partners may start to raise an additional fund, recycling some of the investment success money and adding new limited partner investors. For most of the portfolio companies, returns from the investment, through exit, occur from years four through ten (Wright and Robbie, 20013; Hadzima, 2005).

VC companies are increasingly specialised by stage of development (i.e. start-up, product development, revenue generation, profitable) or by round (i.e. seed, first, second or later stage). Usually, the later the round, the greater the funding invested in a round. Also, the funds close to the end of their life cycle are more likely to invest in later stage deals that are closer to exit, to gain a higher perceived return potential rapidly (Ernst &Young, 2014).

Deal selection skills are crucial for venture capitalists, who perform an important screening and signalling role in the market. In fact, they intensively scrutinise firms before providing capital, based on objective information and analysis, as well as their intuition, "gut feeling" and creative thinking (Hisrich and Peters, 2002; Martel, 2006). They are extremely selective in choosing their investment and are especially interested in businesses with a very high growth potential, which may provide high yields over the medium- to long-term investment horizon, through a successful exit.

Besides the funding, venture capitalists bring in technical and managerial expertise and provide new firms with a bundle of services. These include general business strategy advice, development of a marketing strategy, support to hire key staff, a financing plan and design for an exit, as well as advice for scenarios in which the business does not succeed. Empirical evidence suggests that venture capitalists play a key role in the professionalisation of the start-up companies they finance. At the same time, they may exercise strong control on the management and even drive or impose changes in top management.[3]

On the other hand, entrepreneurs seek a venture partner that may provide expertise, experience, contacts and reputation, alongside funding. There is a value in being associated with experienced and well-connected venture capitalists, to rapidly gain information about markets, to attract highly skilled employees and partners and, at the exit stage, to appeal to good IPO underwriters. Evidence suggests that entrepreneurs are willing to accept a discount on the valuation of their start-up in order to access the capital of venture capitalists with better reputation. In this regard, the reputation of venture capitalists, which depends on their experience, information network, and direct assistance to the portfolio firms, is more distinctive than their functionally equivalent financial capital (Hsu, 2004).

The exit prospect, i.e. the way for venture capitalists to cash out on their investment in a company, is critical in the venture capital industry, as investment decisions are partly determined by the exit possibility. Typically, exit takes the form of an IPO, when the company

shares are sold to the public, or, most commonly, a merger and acquisition (M&A), whereby investors receive stocks or cash from the acquiring company (Gompers and Lerner, 2001; Pearce and Barnes, 2006; Espenlaub et al., 2009). Thus, trends in IPO and M&A markets have an important effect on the VC industry, as in the aftermath of the 2008-09 global financial crisis, when reduced exit opportunities discouraged VC investments and increased time to exit.

An acquisition often involves a sale to a "strategic buyer", such as a supplier, distributor or competitor in the same industry as the start-up, rather than to a "financial buyer", who purchases companies solely for their investment value (Vinturella and Erickson, 2013). Among strategic buyers, large companies play an important role in screening venture capital-backed start-ups, with the aim of identifying early-stage companies that may provide radical innovations or new business models that may be scaled-up, or represent an interesting partner for their open innovation strategy.

Profile of firms

Venture capitalists bridge the financing gap caused by information asymmetry for new and innovative firms. Financing constraints tend to be more acute for young firms to the extent that they have limited internal funds and a track record to signal their ability to investors. The problem may be exacerbated by the lack of collateral for start-ups and the extremely risky nature of new innovative ventures. Indeed, the problem of insufficient collateral, which affects a large proportion of SMEs across all sectors, is exacerbated for companies whose business model is largely based on intangibles, as it is the case for sectors driven by knowledge-based capital investments, such as R&D and design (OECD, 2013a).

Venture capital targets a small pool of high-growth-potential companies with the capacity for high returns in a relatively short time frame. In fact, the venture capital industry is extremely selective and concentrated in sectors with high growth potential from scaling up innovative or disruptive business plans. Only a few firms have the potential to attract interest of venture capitalists, and only a minority is able to secure funding. According to the US National Venture Capital Association (NVCA, 2014), for every 100 business plans that are submitted to a venture capital firm for funding, about 10 are closely examined, and only one ends up being funded.

Typically, firms financed by venture capital feature a high commitment by the entrepreneur to invest his/her own money alongside the external financier, a solid market potential and prospects for high growth and high returns within a relatively short timeframe (35-40% IRR), high R&D spending, a strong and experienced management team, and the willingness of the entrepreneur to give up a significant share of ownership (Industry Canada, 2004).

These criteria account for the concentration of VC investments in a few industries, such as the digital economy (i.e. ICT, internet, electronics) and healthcare sectors (i.e. life science, biotech and medical device technology). In 2012, these industries raised, respectively, USD 8.8 billion and USD 3.2 billion venture capital fund worldwide (Idinvest, 2014). In 2013, ICT companies received the greatest share of VC investments in some of the key global markets, such as the US, Canada and Israel, both in terms of number of deals and value share. In these three markets, the subsectors which attracted most investments were software and consumer information services. In particular, software accounted for 70% of all VC funding to ICT. The preference of venture capitalists for consumer services and ICT can be partly explained by the direct and immediate connection with consumers, which

allows for rapid feedback on whether the investment is likely to pay off, as well as for a fast route to value creation. On the other hand, healthcare sectors are particularly popular in mature markets, such as the US and Europe, where an ageing and wealthy population represents a source of value (Ernst&Young, 2014).

Enabling factors

An enabling environment for innovative entrepreneurship is key for the development of the venture capital industry, which itself can positively affect the entrepreneurial environment (Dossani and Kenney, 2002). In many countries, a major impediment to the development of venture capital is the lack of "investor ready" companies appropriate for VC. A culture of risk-taking and self-confidence, social recognition for an entrepreneurial career, and regulations that ease market entry and exit are among the enabling factors for a critical mass of entrepreneurs to emerge. However, access to knowledge and skills is critical for *innovative* entrepreneurs, which especially benefit from knowledge networks and linkages, at the local and the global level. More broadly, innovative entrepreneurs require – and are pillars of – an open and dynamic innovation system, in which a diverse network of knowledge producers, users and institutions exchange knowledge and cooperate (OECD, 2010a; OECD, 2010b).

Highly innovative enterprises are often spin-offs from research institutions and are closely linked to academia, allowing for the commercialisation of innovative outputs. High growth potential may also be identified in spin-offs from established companies, which harness both technological and market knowledge accrued in the parent company to launch the business.

The technological and sectorial dimension of the innovative opportunities also matters for the venture capital development. In fact, venture capital can flourish when there is a constant flow of opportunities that have great upside potential. Historically, ICT has been the business field that has offered the longest series of opportunities, which explains the high concentration of VC investments in this area (Dossani and Kenney, 2002).

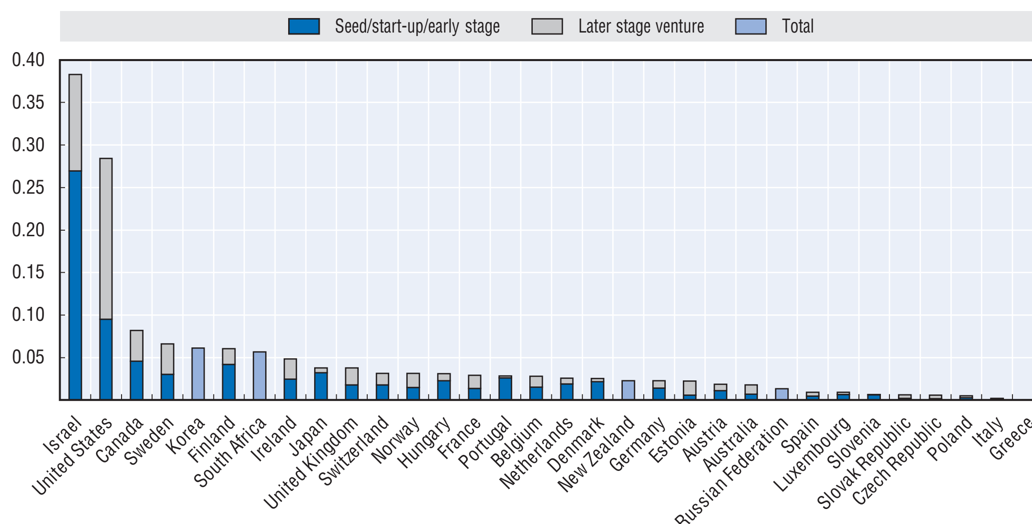
The existence of exit options is another critical factor for venture capitalists. The portfolio companies of a VC fund are typically cash-constrained growth ventures that do not pay dividends in the investment period. Rather, returns are gathered as capital gains when divesting the venture. In this regard, illiquid capital markets, in which venture capitalists find it difficult to sell their shares or engineer an M&A, represent an impediment to VC expansion (Landström and Mason, 2012). It also follows that taxation of capital gains is especially relevant for venture capitalists, as well as start-up entrepreneurs who may expect a return in terms of share participation, although the empirical literature on the effects of taxation on VC investments is not conclusive.[4]

There may exist regulatory barriers to investment in seed and early stage ventures. These include regulation that makes it difficult for venture capitalists to operate as limited liability entities, and regulation that limits the investment in these stages of certain types of institutions, such as banks, pension funds and insurance companies (OECD, 2013a).

Trends in venture capital markets

Across OECD and non-OECD countries, venture capital represents a small fraction of GDP, most often less than 0.05%. The countries in which the industry is relatively more developed are Israel (0.38%), the US (0.28%) and Canada (0.08%) (Figure 7.2).[5]

Figure 7.2. **Venture capital investments as a percentage of GDP, 2014 or latest available year**



Source: OECD (2015).

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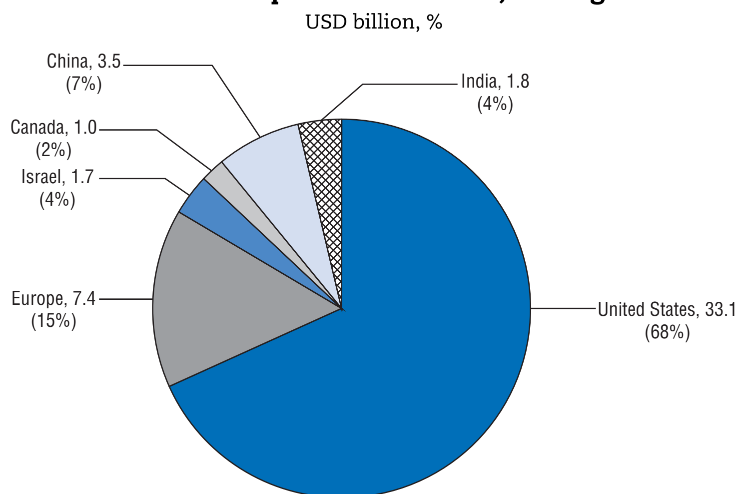
The US VC market is the largest worldwide, accounting for 68% of global VC activity in 2013 (Figure 7.3). Between 1995 and 2010, venture capital investments in the US were on average three times the size of investments in Europe. However, the number of venture capital deals in Europe is higher than in the US; in other words, European venture capitalists disperse funds more broadly through smaller deals (OECD, 2013a).

Figure 7.3. **Annual venture capital investments, main global markets, 2013**

USD billion, %



Source: Ernst&Young (2014), based on Dow Jones Venture Source.

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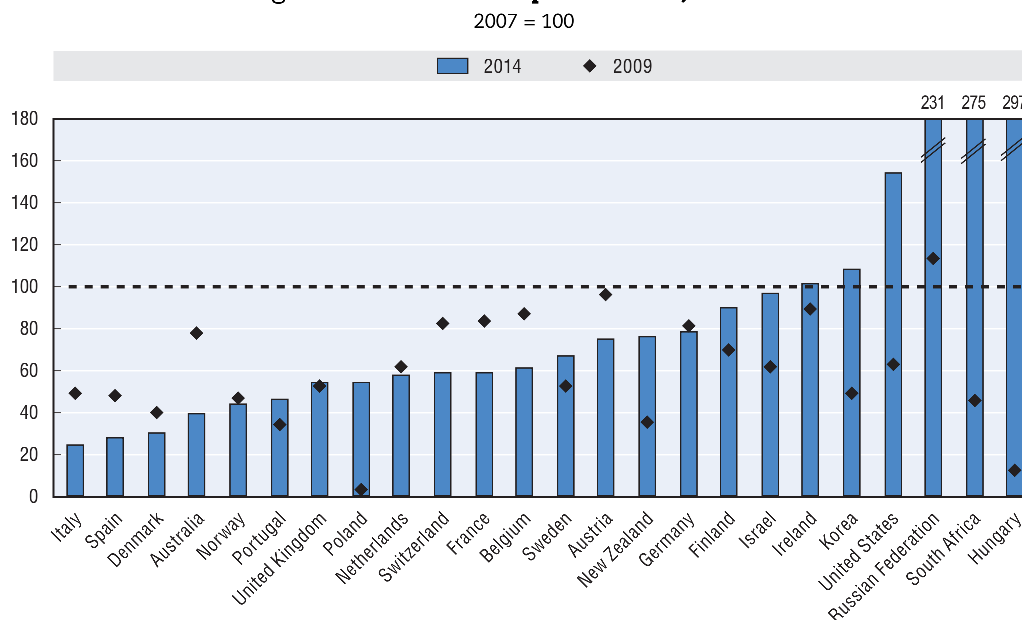
In Israel, the structure of the VC industry is characterised by the prevalence of seed and early stage financing, whereas in the other major markets the greatest portion of VC funding supports later stage ventures, when companies are perceived to be partially de-risked and close to their revenue generation stage. This trend is particularly marked in emerging economies, with China and India recording high median size in second and later

rounds. Nevertheless, in China, with intensified competition between investors in later stage companies, VC funds are increasingly looking towards earlier stage investments, contrarily to what observed in Europe and the US (Ernst&Young, 2014).

The 2008-09 global financial crisis severely affected the industry. In 2014, in most countries the level of venture capital investment was still below the pre-crisis level, and in some cases still below the level it reached in 2009 (Figure 7.4). This is in line with the general downward trend observed in equity markets, in spite of the increasing interest in alternative instruments by investors, in search for opportunities to diversify their portfolio and for higher returns. Although the assets under management of the private equity funds experienced a dramatic surge in the pre-crisis period, the sector has stagnated since 2008 and did not offset the decline in IPOs. In fact, the role of stock markets as a destination for growth companies is decreasing, as reflected in the falling number of IPOs across the globe. Over 2010-13, the number of VC-backed M&A exits also continuously declined. Furthermore, a significant shift has been observed in fundraising through IPOs in equity markets, from OECD economies to emerging economies (OECD, 2013b; Ernst&Young, 2014).

Figure 7.4. **Venture capital trends, 2007-14**

2007 = 100



Source: OECD (2015).

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Policies to enhance venture capital markets

As economies become ever more dependent on innovation and entrepreneurship for achieving sustained growth, venture capital markets have received increasing attention by policy makers, which have deployed a mix of policy instruments, directed at both the demand side (e.g. tax incentives for innovative start-ups, entrepreneurship training, incubators) and the supply side (e.g. tax incentives for risk capital investors, direct and co-investment) (Da Rin et al., 2006; OECD, 2013a).

In 2012, the OECD conducted a survey on policy interventions to sustain seed and early stage financing (OECD, 2013a). The evidence about 32 OECD countries shows that policies largely focus on the supply-side measures, which may be perceived as being more visible

and direct than demand-side support. The main policies observed include *front-end* tax incentives, i.e. tax deductions on investments in seed and early stage ventures, and *back-end* tax reliefs, which relate to capital gains and losses, including rollover or carry forward, and are often intended to encourage investors to reinvest in early stage firms. In the majority of countries, these types of support have increased in recent years, especially in the form of front-end tax incentives (see Box 7.1).

Box 7.1. **Tax incentive schemes for equity investors in SMEs: The case of the UK**

In the UK, the government operates three programmes that provide equity investors in small companies with tax incentives to encourage investment in small and growing higher-risk businesses. The Enterprise Investment Scheme (EIS), first launched in 1994, offers tax incentives to investors who purchase new shares in small higher risk trading companies. Private investors can invest up to GBP 1 million in qualifying shares and receive 30% of the cost of the investment as a relief against their income tax liability. In addition, capital gains tax liability on disposal of an existing asset can be deferred if reinvested in EIS shares within a certain period. If EIS shares are disposed of at a gain, the profit is exempt from capital gains tax. If the investor incurs a loss, this may be set against income tax in some circumstances.

In 2012, the UK government introduced another scheme that offers a range of tax reliefs to investors in small, early-stage companies, the Seed Enterprise Investment Scheme (SEIS). Shares must be held for at least three years and income tax relief is available at 50% of their cost, up to GBP 100 000. SEIS provides 50% exemption on capital gains reinvested in SEIS. If SEIS shares are disposed of at a gain, the gain is exempt from capital gains tax. If the investor incurs a loss, this may be set against income tax in some circumstances.

The third programme, Venture Capital Trust Scheme (VCT), started in 1995, offers a relief against income tax at 30% of the investment cost, up to GBP 200 000 to incentivise individuals to make indirect investment via intermediaries into small and growing higher-risk businesses. Investors buy shares in a VCT, which must fulfil a number of qualifying criteria including being listed on a primary stock exchange. The VCT then onwardly invests into qualifying companies, primarily through equity or quasi-equity instruments. The investor must hold their shares in the VCT for 5 years to qualify for the tax reliefs. Dividend payments and capital gains on the shares in the VCT are also exempt from the respective taxes.

Source: BIS (2013), *www.hmrc.gov.uk*.

If tax incentives are aimed at favouring investments by the private sector, government equity programmes are the common direct form of intervention to sustain the VC supply side. These include direct investment in start-up companies through government funds, fund-of-funds and public/private co-investment funds. According to the 2012 OECD survey, these programmes have been increasing in the recent past, especially fund-of-funds and co-investment funds, both of which seek to leverage private sector investment. In particular, co-investment funds, whereby public funding matches private investment, are often seen as a driver in building, growing and professionalizing the seed and early stage investment market. The majority of these funds are *pari passu* (on the same terms), but some schemes are asymmetric, i.e. they provide a premium to private sector investors, which get a higher proportion of the returns and a smaller share of the losses (OECD, 2013a).

An example of *pari passu* co-investment fund is the New Zealand Seed Co-Investment Fund (SCIF), which was launched in 2005 to provide matched funding for seed and early stage firms alongside "approved" private partners, typically private investor groups, including business angels or syndicates. The purpose of the fund goes beyond the direct funding to new ventures, as it also aims at catalysing private funding, enhancing networks for early stage investments and increasing the depth of specialist skills needed to assess and manage these investments (OECD, 2013a).

The attraction of foreign investors can help to train and develop local investors, as it was the case with Israel's Yozma Programme, which kick-started the country's VC industry in the 1990s (Box 7.2). However, only a few OECD countries have structured programmes in place to attract foreign investors, although in some cases equity and tax programmes are open at foreign investors. An exception in this regard is Australia's Venture Capital Limited Partnerships programme (VCLP), which aims at increasing foreign investment in the Australian venture capital sector. It does so by offering exemption from capital gains tax to

Box 7.2. **Attracting foreign investors to build a national venture capital industry: The case of Yozma programme in Israel**

The Israeli venture capital industry was built through government funding which leveraged financing from foreign corporations and institutions. The government created the YOZMA group in 1993 to use public funds to leverage foreign financing, primarily from the United States. Co-investors also included financiers from Germany and Japan. This was accompanied by equity guarantees for foreign investors, programmes to link Israeli firms with foreign business angels, and exits of Israeli venture firms on foreign stock exchanges.

In more detail, in 1993 the Israeli government supplied USD 100 million to start YOZMA, a venture capital fund investing in high-technology start-ups, mainly in ICT and life science/biotechnology sectors. This leveraged funding by foreign investors, under the obligation for the new VC funds to invest in start-up companies in Israel. Over a period of three years, the Group established ten hybrid public/private funds, each capitalised with around USD 20 million. In parallel, YOZMA started making direct investments in start-up companies. A five-year option was given to private partners to buy out the Government's share at predetermined conditions. This option was exercised in most cases, leading to the privatization of the VC funds. Initial individual investments typically ranged between USD 1 million and USD 6 million, and additional capital was reserved for follow-on investments. With the backing of prominent American, European and Israeli investors, YOZMA launched its second fund in 1995. Investment decisions regarding where and how to invest were mainly taken by the international partners.

The YOZMA Group also developed close working relationships with several of the leading academic institutions and technology incubators in Israel. Some of the most promising companies in the YOZMA portfolio have come directly from these institutions. As part of its efforts to involve senior executives and founders of successful enterprises in the activities of YOZMA, the Group created the YOZMA III CEO Club, which became a valuable source of deal flow.

By 2000, the Israeli venture capital industry had reached the stage whereby the private sector led the public sector in investments. The government phased out both the YOZMA equity programmes and the equity guarantees in the late 1990s when the success of the pump-priming efforts was evident.

Source: Baygan (2003).

fund managers that seek to raise a new VC fund of at least AUD 10 million for investment in Australian businesses with assets of up to AUD 250 million. Also, registration with the scheme entitles a fund to flow through taxation treatment, i.e. only the investors are taxed on revenues, not the entity itself (OECD, 2011b).

The 2012 OECD study highlights that demand-side policies are often overlooked in countries policy mix, although a recent growth in demand-side programmes, such as match-making and networking services, incubators and accelerators, is observed. In recent years, a new generation of "accelerators" developed, which provide tailored mentoring and support to a small group of entrepreneurial teams, selected on a highly competitive basis. Both incubators and accelerators provide business strategy advice, mentorship and workspace in a business-fertile environment, but differ in the pace of the support (much faster for accelerators) and the model for supporting start-ups financing. Whereas business incubators ease the linkages of entrepreneurs with prospective financiers, including venture capitalists, accelerators seed-invest in start-up companies, in exchange for a certain amount of equity. This is the case of the Vigo programme in Finland, which aims to fill the gap between early stage technology firms and international venture funding. It does so by carefully selecting "accelerators", which are independent companies run by internationally proven entrepreneurs and executives. These accelerators help start-ups to grow faster and access the global market, by co-investing with the new ventures.[6]

The networking side is even more important as public equity markets stagnate. If IPOs on stock exchange are difficult, the main option for entrepreneurs and their investors to realise gains is to sell or merge their firm with another company at an appropriate time. Building links with investors and large companies can increase the opportunities for this type of exit (OECD, 2013a).

Also, an increasing concern about the lack of entrepreneurial skills and capabilities and low quality of investment projects is driving attention on measures that target the skills of existing or would-be entrepreneurs. This is the case of investor readiness programmes, which help entrepreneurs anticipate the need of investors and prepare for submitting their funding demand. For instance, Impact Invest Scandinavia support ventures that are in early commercial phase or wish to seek capital to scale-up, by providing training and access to a global network of investors.[7]

Business angels

Modalities

Business angels (BAs) are high net worth individuals who invest their own money directly in seed or start-up companies, with no family relationships, in return for stock in the companies (Mason and Harrison, 2008). Thus, BAs capitalise their returns by disposing of the start-up shares, through an IPO, a merger or an acquisition, and often re-invest the gains into new ventures. This is the case also because a BA is typically financially independent, i.e. a possible total loss of the angel investments will not significantly change the economic situation of his/her assets.

BAs are often former successful entrepreneurs who are interested in supporting other entrepreneurs by providing both funding and expertise. As it is the case for VCs, BAs generally take an active involvement in the start-up company, providing strategic and operational expertise, as well as connections to other key players in the system. Typically, BAs make investment decisions based on their experience in a particular sector and invest in

companies within their local area (OECD, 2011a). Indeed, with respect to venture capitalists, BAs are usually less deterred by gaps in the start-up management team, because they can contribute missing expertise through their own involvement (Mason and Stark, 2004).

In spite of their direct engagement in the management of the start-up, often BAs wish to remain minority shareholders, as they are aware of additional funding needs of the entrepreneur at later stages, to which other investors may respond, and prefer that the entrepreneur remains in control of the business with significant stake in the result and incentives to succeed (OECD, 2011a).

Angel investing of this sort has existed for centuries, but, over the past couple of decades, the angel investment sector has gained increasing recognition, as a powerful source of financing for high-growth companies, and has become more formalised and organised, including through syndicates, associations and networks (Ibrahim, 2008; OECD, 2011a).

Recognition has come with more regulation, although the angel investing market is largely informal, i.e. BAs act privately and generally prefer to maintain anonymity (CSES, 2012). In the US, angel investors need approval as "accredited investors" under securities laws, whereas in other countries certification is necessary but can take the form of a self-certification. These requirements are intended to ensure that the investors have the necessary financial resources as well as an understanding of the implications of investing in start-up companies (OECD, 2011a).

The typical angel investment size is in the range of USD 25 000-500 000, that is, BAs operate in a seed/early stage investment segment which falls in between informal founders, friends and family and formal venture capital investments (see Table 7.2). Since VC is increasingly focused on later stage investments, to some degree BAs are filling the financing gaps in the early stages (OECD, 2011a). Angels may therefore be seen as providing a vital kick-start to innovating businesses both in terms of investment and business-building skills (Wiltbank, 2009).

BAs tend to invest in a portfolio of companies, diversifying risk, and can operate alone or invest jointly with other institutional investors, for example in a seed fund, or join forces with other BAs. This is the case of formal or informal syndicates (or groups), in which experienced angels pool their capital and expertise to achieve a critical mass and offer a broad range of managerial skills. Furthermore, investing through a syndicate allows BAs to assess a wider range of deal opportunities and to identify potential co-investment partners. Usually the investor pays for the syndicate, and the syndicate will assess the potential investment for the BA to make the final decision. Syndicates may be member-led, i.e. managed by a lead angel or a committee, or may be run by professional managers. In any case, members are generally allowed to make their own investment decisions, although minimum annual investment requirements may be set by the syndicate (OECD, 2011a; CSES, 2012). The recent growth in BA syndicates may be related to the increased awareness about angel investment opportunities and a greater demand for pooled angel capital, to fill the market gap between individual angel investment and venture capital (OECD, 2011a).

In recent years, Business Angel Networks (BANs) have diffused at the local and national level, particularly in Europe. BANs do not invest themselves in start-ups, but rather play a match-making function between angel investors and entrepreneurs. They help increase the visibility of the angel activity in a region, without necessarily making the individual BA more visible, as they act as a "front door" for entrepreneurs looking for financing (OECD, 2011a). BAs that are associated to the network make their own individual

investment decisions, and the BAN does not decide which investors will invest in a deal. BANs also often provide a number of added value services to both angels and entrepreneurs, such as investment readiness or syndication opportunities (CSES, 2012). BAN operating model, membership criteria and sectorial orientation greatly differ across countries and regions. They may focus on particular sectors, gather groups of people with similar backgrounds, experiences, cultures or nationalities (e.g. university alumni, diaspora groups) or include also service providers and other non-angel financial investors (OECD 2011a; OECD, 2013a).

Increasingly, BA syndicates and networks are using online tools to favour the matching process. In addition online matching platforms have developed, which provide matching services to registered investors and entrepreneurs. Although these platforms can reduce information search costs for both the investors and entrepreneurs, they do not replace personal contact and face-to-face interaction, which are mostly needed in a financing model largely based on confidence and trust (OECD, 2011a).

Business angels vs venture capital

Business angels and venture capitalists act and interact in a common space of opportunities, that of innovative, high growth potential start-ups, but are characterised by different motivations, targets, scale and operating models (Table 7.3).

Table 7.3. **Key differences between angel and venture capital investors**

Characteristics	Angel investors	Venture capitalists
Background	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Range of seed, early stage and later stage but increasingly later stage
Investment instruments	Common shares (often due to regulatory restrictions)	Preferred shares
Deal flow	Through social networks and/or angel groups/networks	Through social networks as well as proactive outreach
Due diligence	Conducted by angel investors based on their own experience	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.)
Geographic proximity of investments	Most investments are local (within a few hours' drive)	Invest nationally and increasingly internationtally with local partners
Post investment role	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Important but not the main reason for angel investing	Critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Source: OECD (2011a).

First of all, although capital gains represent a common and primary objective, the non-financial motivations of BAs, and their entrepreneurial background, often imply they are willing to consider a wider range of sectors than VC funds, including non-high-tech fields, and geographical areas that are different from VC hotbeds. Whereas venture capitalists must produce returns for VC investors, the use of personal funds gives BAs the flexibility to invest for non-financial reasons and target sectors and local areas in which they may give back to the entrepreneurial community through "for-profit philanthropy" (Ibrahim, 2008).

The non-financial value that BAs can bring to a project is an important factor in their decision to invest. This also implies that, although in both cases financiers have an active role in the management of the investee business, BAs tend to take a more hands-on role in the company than VCs and place greater importance on their relationship with the entrepreneur. These differences in the investment motivations are also reflected in the emphasis that they give to growth potential, with greater emphasis by VCs on businesses that may become significant global players (Mason and Stark, 2004). Also, the non-financial motivations for angel investment help to explain the greater use of informal contracts, whereby the investor does not apply highly protective terms in order not to signal a lack of trust in the entrepreneur (Ibrahim, 2008).

The stage of investment and scale of funding are other important differences between the two financing models. BAs target seed and early stage ventures, investing relatively small amounts per venture, whereas VC funds (increasingly) focus on later stage investments and need sufficient scale to be able to provide multiple financing rounds.[8] Hence, angel investors have much lower cost structures than VC funds. The early stage of investment by BAs, and the little historic performance data on which judgements about investments can be based also explain their greater weight on the attributes of the founders of businesses, when screening deal opportunities (Stuart et al., 2007). However, the growth of BA syndicates or "super angels", wealthy individuals – often serial entrepreneurs – that attract also capital from other investors, has created a segment in-between the angel and VC market, in which operating models and contractual relationships are close to those of the VC industry, with full time managers getting a share of the investment profits (OECD, 2011a).

There are also important complementarities between angel and venture capital investors, which Harrison and Mason (2000) synthesise in: sequential investing in businesses at different stages of business development; co-investing in deals; provision of finance to venture capital funds; and deal referring.

Firstly, BAs provide start-ups with small scale early-stage capital, which is often followed by larger-scale second and subsequent stage capital by VCs. In fact, investment by BAs often serves as a signalling effect for other investors, demonstrating that the firm has passed a first screening of due diligence by investors with experience in the field. Furthermore, the interest by VCs may provide an interesting exit route for BAs to realize their investment (Harrison and Mason, 2000). At the same time, it is more frequently observed that BAs themselves support the investee company through exit, instead of relying on VCs to step in. This is especially the case for firms in the internet and social networking sectors, which require smaller amounts of initial capital that traditional high tech fields, and are characterised by more rapid testing and adjustment of products or business models (OECD, 2011a).

BAs may also invest jointly with VC funds. VC funds are increasingly recognising the contribution of angels and, in some cases, are collaborating on early-stage investment with them (OECD, 2011a). The BA typically benefits from reduced risk and better quality investment opportunities, given the screening on a higher number of potential deals by VCs. On their hand, VCs can benefit from the BA's experience in the sector and direct engagement in the management of the start-up. This is especially relevant for relatively small deals, in which the opportunity cost of management time may be considered too high by VCs. Also, the presence of angel investors among the funders usually implies that the capital is more "patient" than in the case of institutional investors, reducing the pressure on VC fund managers to generate rapid returns (Gifford, 1997; Harrison and Mason, 2000).

High net worth individuals, including BAs, are among the financiers of VCs. The investment in VC funds represents for the BA an option for diversifying the portfolio risk and may be attractive if the angel investor has difficulties in evaluating investment opportunities and structuring deals, as it may be the case for individuals with time constraints, poor referral networks or lack of experience in the industry (Harrison and Mason, 2000).

Deal referring is another area of complementarities between BAs and VCs. The network of a BAs can represent an important source of investment opportunities for VCs. At the same time, VCs can provide BAs with access to funding deals that are outside their resources or expertise. According to Harrison and Mason (2000), which analyse the UK venture capital market, cross-referring of investment opportunities is the most commonly cited form of complementarity by VCs, while BAs tend to highlight the importance of co-investing to a greater degree.

Profile of firms

Angel investment concerns mainly seed and early stage companies, including young firms that are beyond the start-up phase but need capital to develop their product or business strategy. BAs invest largely, though not exclusively, in knowledge-based sectors. In fact, compared to VCs, BAs invest in a wider range of sectors, including traditional ones, and geographies, which are not limited to VC hotbeds and are typically related to the BA's entrepreneurial experience and personal networks. However, a common trait of the target companies is a high-growth potential and likelihood to generate substantial revenues over the mid- to long-term (3-8 years). In other terms, BAs and VCs look for scalable investments, that is, companies that can substantially grow their revenues within a few years (Villalobos and Payne, 2007).

As is the case for VCs, angel investors bridge the financing gap for new ventures that is largely due to information asymmetry. Since they tend to invest in an earlier stage of the business development than VCs, for BAs the asymmetry may be even more relevant. This also explains the greater emphasis placed by BAs on the personal relationship and trust with the entrepreneur, who should be willing to relinquish some control on the firm and accept an active role of the BA in the development of the business strategy.

Generally, the most appropriate time for companies to seek angel investment is when a product or service is developed or near completion and there exists a base of customers or potential customers that confirmed their interest in buying it. BAs are usually under little pressure to make an investment in order to generate income or capital growth. They can afford to wait until they identify the right opportunity and the right person. This means that entrepreneurs that seek angel investments need to be able to present not only an appealing idea and business plan but also themselves effectively (Stuart et al., 2007).

Enabling factors

For the angel investment model to work and the market to grow, a well-functioning entrepreneurial ecosystem is needed (OECD, 2011a). Similarly to the VC sector, BAs need a critical mass of high-growth opportunities, to screen and select appropriate ventures and scalable business models. Therefore, a diffused culture for risk-taking, social recognition for an entrepreneurial career, low barriers to market entry by new entrepreneurs and high levels of appropriability of the returns from innovation are all factors that favour opportunities for angel investment to emerge. Also, access to knowledge and skills for entrepreneurs to launch innovative businesses is crucial. These are not confined only to

high-tech sectors, for which good linkages with R&D centres and Universities are essential, but may concern traditional or mature industries, in which opportunities to rapid growth may exist for innovative start-ups.

Angel investing benefits from an integrated and well-functioning financial system, which allows profitable exit to take place, through IPOs or trade sale. In this respect, secondary stock markets in which SME shares are traded can provide an important channel for BAs to realise their investments. A well-developed VC market can also provide BAs with an effective exit route.

Angel activity benefits from broader synergies with the VC industry. BAs need a well-functioning VC market to provide the follow-on finance that some of the businesses they support will require. At the same time, a well-developed angel market can create more investment opportunities and increase the deal flows for VCs (Harrison and Mason, 2010).

Awareness about angel investment opportunities is relevant for the growth of the industry, to attract would-be BAs and to raise the interest of entrepreneurs that seek early-stage funding. In many countries, the development of BANs and online platforms has improved the visibility of the angel market at the local level and reduced the information gap between angel investors and entrepreneurs. Until recently, entering a deal with a BA was often a challenge for entrepreneurs, which had to work their personal networks to identify and meet potential financiers and then negotiate privately. The match-making services offered by BANs can substantially reduce the search costs and time and increase the likelihood that valuable projects get financed. The visibility of the industry has also improved with the diffusion of angel groups or syndicates, which are generally easier to find for entrepreneurs than individual angel investors (OECD, 2011a; Ernst &Young, 2014).

Trends in business angel investments

Analysing trends in angel investments is difficult, due to the lack of data and little harmonization in definitions. Currently, the only data available is that collected by angel associations from angel groups and networks. This however only captures the "visible" market and overlooks the largest part of investments, which are carried out by individual BAs. It has been estimated that, when taking into account the "invisible" share of the market, the total amount of angel investment is likely greater than VC investments (Kerr et al., 2010).

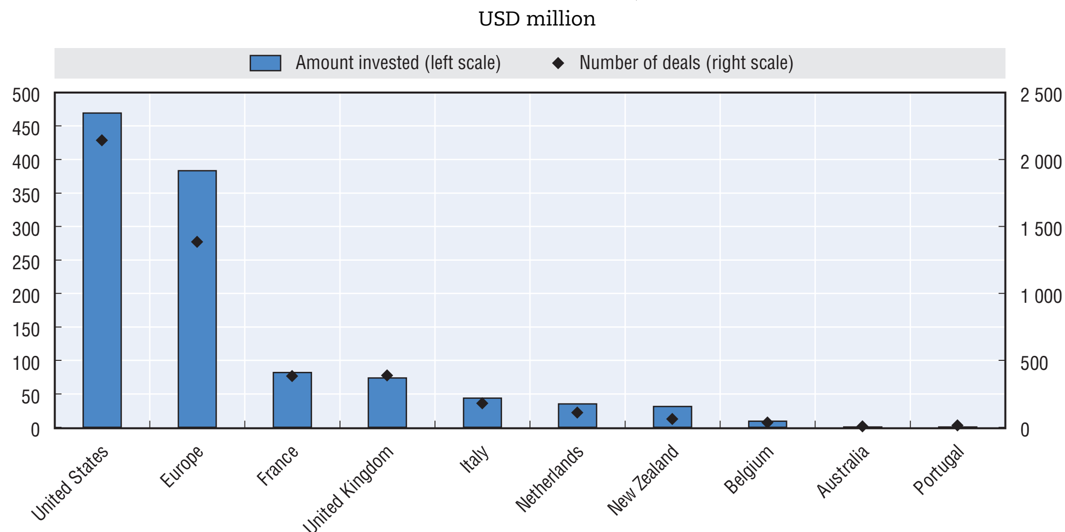
Taking this important limitation into account, OECD (2011a) shows that the US and Europe are the most active BA markets, with France and the UK leading the European market (Figure 7.5). In the US, angel investment boomed in the dot com era, rising at a high pace and then falling off, as did venture capital. The constant growth of BA activity over the last decade came to a halt during the 2008-09 financial crisis, though the fall was not as dramatic as in the VC industry (OECD, 2011a). In this regard, BAs appear to be less sensitive to market cycles than are professional VC investors. Nevertheless, also for BAs the lack of opportunities represents an important challenge, which may discourage or defer investment in the first place.

Overall in Europe, in 2009, total investment through angel networks had already surpassed the seed component of the VC industry (Figure 7.6), which may be also explained by the increasing orientation by VC funds towards later stage financing. BA investment in seed/early stage VC funds has also increased in recent years (OECD, 2011a; Ernst&Young, 2014).

Although BAs invest across a broad range of sectors, the VC-preferred fields (ICT and healthcare sectors) feature high in BAs' investment choices. According to the European

Figure 7.5. **Investments by business angel networks/groups in selected countries, 2009**

USD million

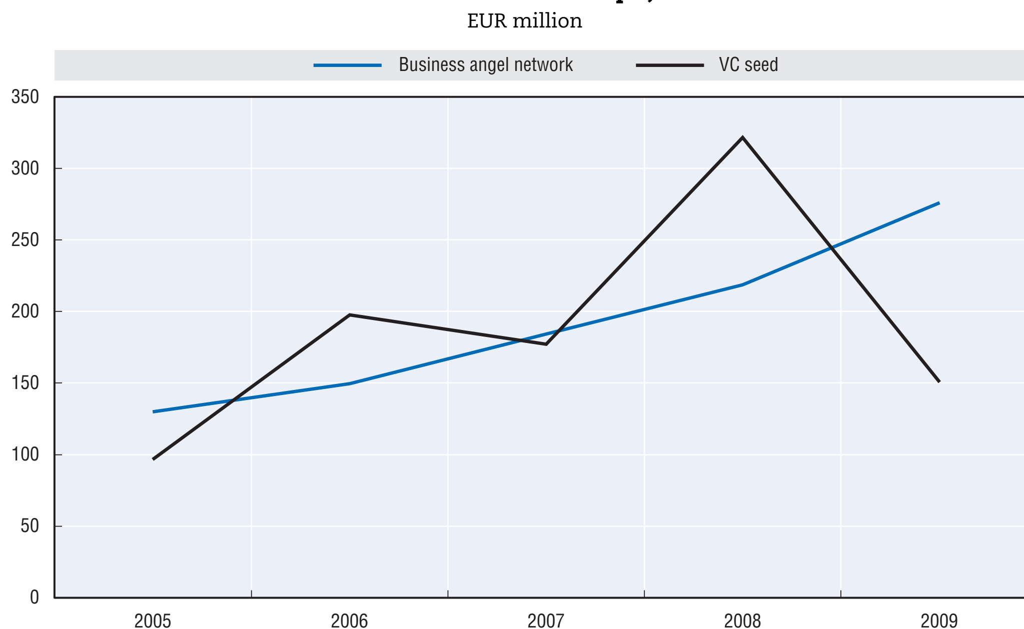


Source: OECD (2011a).

StatLink http://dx.doi.org/10.1787/888933292258

Figure 7.6. **Business angel network and venture capital seed investments in Europe, 2005-09**

EUR million



Source: OECD (2011a).

StatLink http://dx.doi.org/10.1787/888933292267

Business Angels Network (EBAN), in 2013, in Europe, ICT collected 32% of investment preferences, followed by Biotech and Life Sciences (10%) and Mobile (10%).[9]

Only a minor share of BA deals are cross-border, whereas most investments are local. This may be related to the importance of personal relationship and trust in the angel investment process. Cross-border deals are only possible when the necessary trusted

relationships are in place, there is sufficient knowledge about the market and the legal and tax systems permit BA types of deals (OECD, 2011a).

Policies to sustain business angel investment

Angel investing is increasingly encouraged and supported by policy makers in many countries, as a way to mobilise financial resources and entrepreneurial expertise towards dynamic new ventures. In most cases, supply-side measures have been introduced, which mainly take the form of tax incentives and public co-investment. Given the local dimension of angel investing, in some countries, such as the US and Canada, support is provided at the local level rather than at the national level.

Front-end and back-end tax incentives aim to increase the number of BAs as well as the amount of capital invested. Typically, incentives are conditional on the shares being held for a minimum number of years or the capital gains being reinvested in new ventures. For instance, in 2008, Italy introduced tax relief for business angel investments, which consists of a tax exemption for capital gains on the sale of a start-ups' undertakings, provided that the start-up is less than seven years old, that the investor holds the shares for at least three years, and that the capital gains are reinvested in another start-up in the next two years (OECD, 2014a).

Japan has introduced an angel tax system since 1997, which comprises reduced taxation on capital gains and carry forward of losses. However, as angel taxation was only used for a small amount of investments, to further increase angel funding, the system was amended in recent years with the introduction of an income exemption system, whereby, under specific conditions, BAs can deduct from their annual income an amount of money substantially equivalent to the investment carried out in the same year (OECD, 2011a).

Another common supply-side measure consists in the creation of co-investment funds, which match public funds with those of private investors that are approved under the scheme. In some cases these funds target all seed and early stage investors, including also VC funds (see Box 7.3), but there exists also programmes that are especially focused on BAs. In the UK, the Angel CoFund invests amounts of GBP 100,000 to GBP 1 million into SMEs with high growth potential, working in partnership with syndicates of experienced BAs.

In some countries, public support has been provided to BA associations, networks or groups to help start these organisations. For instance, EBAN was created in 1999 as a federation of BANs across Europe with financial support of the European Commission. In the US, it was the Kauffman Foundation which supported the creation of the Angel Capital Association (ACA) in 2004. In some cases, however, the public support to start national associations did not produce the desired impact, due to relatively immature markets and the difficulty for these associations to build enough momentum to develop (OECD, 2011a).Some policy measures target the specific skills required for angel investing, promoting training, mentoring and coaching, although this type of measures have been less popular than tax incentives or financial support. In the US, the Kauffman Foundation created the Angel Capital Education Foundation (ACEF), which offers education programmes about angel investing, with the engagement of experienced angel investors as lead instructors (OECD, 2011a).

On the demand-side, investment readiness programmes are intended to help entrepreneurs develop their business plans and presentations, in order to appeal to angel investors. To do so, emphasis is placed on better understanding the needs and expectations of potential investors and how to present a business plan that appeals to these expectations.

Box 7.3. **Co-investment funding in seed and early stage ventures: The TechnoPartners Seed Facility in the Netherlands**

In the Netherlands, TechnoPartner is an integral programme that aims to improve the economic climate for technology-based start-ups ("technostarters") by: giving technostarters access to capital, knowledge, experience and equipment; motivating knowledge institutes and investors to invest money and knowledge in pioneers; providing a platform where technostarters can ask questions, explore ideas and make comments.

TechnoPartner carries out four programmes

- TechnoPartner Knowledge Exploitation Subsidy
- TechnoPartner Seed Facility
- TechnoPartner Certificate
- TechnoPartner Business Angel Programme

The TechnoPartners Seed Facility matches funds from both VC firms and BA syndicates. Participating funds that invest in high risk "technostarter" can apply for a loan, for a maximum of 50% of the fund's investment and up to EUR 4 million. The scheme is characterised by a three phase payback period mechanism. Once revenues are generated the fund will have to pay back 20% until it has earned back its investment. After that, the fund will have to pay back 50% until TechnoPartner has earned back its investment. If revenues still accrue, the additional income is divided between the fund and TechnoPartner on a 80% - 20% basis.

Under the TechnoPartner Business Angel Programme (BAP), TechnoPartner informs (starting) entrepreneurs and starting informal investors (virgin angels) about the possibilities of informal investment. Within this framework TechnoPartner uses information sessions on starting capital and a booklet "Starting Capital".

Source: http://erawatch.jrc.ec.europa.eu; OECD(2011a).

Other measures that aim to improve information flows and networking opportunities between financiers and entrepreneurs, including business incubators and accelerators, may also concern BAs. The support to broader networking activity in the entrepreneurial ecosystem may also improve the exit prospects of BAs, as these are able to strengthen linkages with other players, such as VC funds, which may step in at a later stage of the investment, or large companies, which might become M&A partners.

Public equity: specialised platforms for public listing of SMEs

Modalities

For decades, private market participants and officials have been seeking to encourage the development of specialised exchanges or similar trading platforms to satisfy the demand of SMEs for equity finance. Public listing of SME equity through primary and secondary issuance has the potential to provide funding for a company's growth and can increase the availability of, and improve conditions for, subsequent debt financing. Existing SME owners can realise their capital gains and tap a wider investor universe, including retail investors and sophisticated long-term institutional investors (OECD, 2014c).

In this method of financing, an SME issues equity on a public market[10] while simultaneously disclosing basic information about the company's activities and financial situation, usually through a prospectus. Once it is listed, the company is required to make

regular disclosure, and trading takes place under rules established by the exchange.[11] These exchanges are usually regulated by a securities regulatory authority, but the regulator may delegate the authority to set rules to the exchange itself or to other "self-regulatory organisations" (SROs).

SME trading platforms can take the form of a separate board within an established exchange market and operate in parallel with the main market or can be developed as a separate market. This latter is the case of some of the most developed platforms, such as AIM (Alternative Investment Market), London Stock Exchange's (LSE) international market for growing small businesses, KOSDAQ in Korea and TSX-V in Canada. As regulated equity markets, SME listings exclude the least regulated or unregulated over-the-counter (OTC) markets, where securities or derivatives are bought and sold directly between the purchaser and seller.

In most cases, new markets adopt a "junior market" strategy, in which listed firms graduate to the main market, i.e. the companies listed on the SME exchange are allowed to migrate to the main market as and when they meet its listing requirements. Acting as a "feeder" for the main market, the new market may offer visibility to listed firms and be used as an alternative to venture capital rounds. Important exceptions exist, such as NASDAQ in the US and KOSDAQ in Korea, which started as platforms competing with the main market and still hold a competitive position by retaining large venture-backed firms (Yoo, 2007; Gadha et al., 2010).

Compared to the main stock exchanges, specialised platforms for SMEs, or "new markets", set looser listing and disclosure requirements, typically allowing more relaxed criteria on operating history, minimum number of shareholders, past financial performance and number of free-float shares, i.e. outstanding shares that are held by investors other than restricted shares which are held by company insiders. Also, most new markets charge lower listing and maintenance fees than the main market. At the same time, new markets typically adopt operating practices to preserve investor interest and market integrity. These include a lock-up period for major shareholders around equity offerings (i.e. a predetermined period following an IPO where large shareholders are restricted from selling their shares), institutional arrangements for mentoring, and strict delisting rules (Yoo, 2007).

As a case in point, the entry criteria for London Stock Exchange's AIM, launched in 1995, do not include requirements for trading record, minimum size, prescribed levels of shares held by the public, nor they demand pre-vetting of admission documents by the Exchange or by the United Kingdom Listing Authority (UKLA) (Table 7.4). The AIM Rules do not mandate any corporate governance code or disclosures. However, companies need to provide details on their website as to whether or not they have followed a governance code and, if they have not, narrative details of their practices. Furthermore, to ensure investor protection, during the admission process and its time as a public company, the firm must work closely with a Nominated Advisor ("Nomad"), a corporate finance advisor approved by the LSE, who is responsible for confirming to the LSE that certain rules have been complied with. A Nomad undertakes extensive due diligence to ensure that a company is suitable for AIM, provides guidance throughout the flotation process, prepares the company for being on a public market, helps prepare the AIM admission document, confirms appropriateness of the company to the Exchange, and acts as the primary regulator throughout a company's time on AIM (LSE, 2010).

Table 7.4. **Differences between admission criteria and continuing obligations for London Stock Exchange's AIM and main market**

AIM	Main market
• No minimum market capitalisation	• Minimum market capitalisation
• No trading record requirement	• Normally three-year trading record required
• No prescribed level of shares to be in public hands	• Minimum 25 per cent shares in public hands
• No prior shareholder approval for most transactions[1]	• Prior shareholder approval required for substantial acquisitions and disposals (Premium Listing only)
• Nominated Adviser required at all times	• Sponsors needed for certain transactions (Premium Listing only)
• Admission documents not pre-vetted by the Exchange or by the UKLA in most circumstances. The UKLA will only vet an AIM admission document where it is also a Prospectus under the Prospectus Directive	• Pre-vetting of prospectus by the UKLA

1. Unless the transaction is a reverse takeover or disposal resulting in a fundamental change of business.
Source: LSE (2010).

To gain investor trust and reduce the risk perceived by investors in the equity of small, high-growth firms, an opposite approach may be taken, with higher standards in the new market than in the main one. This is the strategy adopted by Brazil's Novo Mercado, a listing segment of BM&F Bovespa (São Paulo Stock Exchange) for companies that voluntarily abide to additional obligations, which are intended to increase shareholders' rights and enhance the quality of information commonly disclosed by listed companies under the Brazilian Law and CVM (Brazilian Securities and Exchange Commission). The companies' commitment to fulfil additional listing requirements is stipulated in an agreement with BOVESPA that gives the exchange authority to oversee and enforce its regulations and even to impose penalties when necessary. In light of these stricter rules, when Novo Mercado was created in 2000, two intermediate corporate governance level were established, to ensure that already listed companies had a path to follow toward improving their corporate governance practices (Box 7.4). These intermediate segments between the traditional BOVESPA market and the Novo Mercado are intended to serve as stepping stones that facilitate gradual adaptation by companies when direct migration to the top level is not considered feasible (Santana et al., 2008).

Box 7.4. **Principal requirements for companies listed in the special corporate governance segments of the BOVESPA market (São Paulo Stock Exchange), Brazil**

Novo Mercado

Transparency: Improvements in the disclosure of financial data, including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor. Present the annual financial statements in an internationally recognised standard (International Financial Reporting Standards or US Generally Accepted Accounting Principles). On a monthly basis, disclose information about the company's securities and its derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R$ 200 000, or one per cent of the company's net worth, in a 12-month period, the company must inform BOVESPA.

Corporate governance and shareholders' rights: Issue only voting shares. Give tag-along rights to all shareholders at the full price of the deal. Make a public tender offer at least at the economic value in case of delisting or cancellation of the Novo Mercado's contract with

Box 7.4. **Principal requirements for companies listed in the special corporate governance segments of the BOVESPA market (São Paulo Stock Exchange), Brazil** *(cont.)*

BOVESPA. The board of directors must have a minimum of five members, all with unified mandates of up to two years, and a minimum of 20 per cent of independent board members. Discuss through arbitration any shareholder-company dispute that arises related to the listing rules, the company bylaws, Corporate Law provisions, and other norms of the Brazilian capital market. The company also commits to maintain at least a 25-per cent free float.

Level 2

Requires companies to abide by all of the obligations set forth in the Novo Mercado regulations, with a few key exceptions. First, Level 2 companies retain the right to maintain existing preferred shares and issue new ones up to the level permitted by the law. These preferred shares enjoy tag-along rights at the minimum of 80 per cent of the price received by the selling controlling shareholder and are also entitled to voting rights in some key situations (such as company mergers and incorporations and contracts between the controlling shareholder and the company), provided they are voted in a general shareholders' meeting.

Level 1

Requires companies to become more transparent by disclosing additional information, such as more comprehensive financial statements (including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor). On a monthly basis, disclose information about the company's securities and their derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R$ 200 000, or one per cent of company's net worth in a 12-month period, the company must report the details to BOVESPA. Listed companies should also maintain, at least, a 25-per cent free float.

By 2002, BOVESPA had amended its mandatory listing rules to require that any new listings involving a public share offering must be registered, at a minimum, as Level 1.

Source: Santana et al. (2008).

Exchanges can also offer SMEs with a variety of services other than the venue for the trading of their securities. For instance, they can connect SMEs to different types of investors (such as angel investors, VC and private equity) and help them gain access to ancillary professional services, such as stakeholder coordination and management, due diligence and prospectus writing, investment case development, IPO roadshow support and financial PR and marketing services. The exchange can also connect companies to professional services such as accountants and legal advisors, which can increase the quality of their financial reporting, thus also supporting investors considering the investment in SMEs (Oliver Wyman, 2014).

Profile of firms

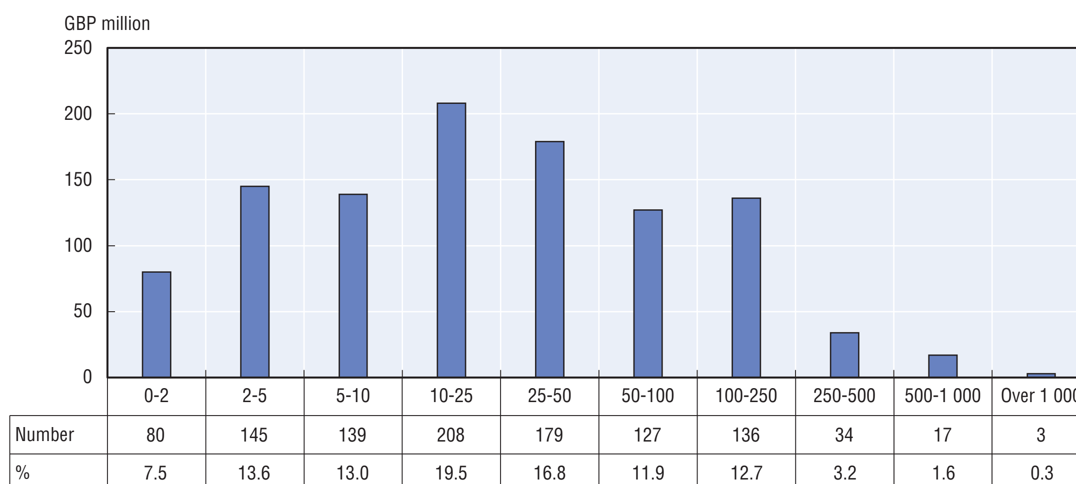
The major public equity markets in the world are dominated by large companies, partly because investors are attracted by their high volumes of tradable equity. These companies usually have highly structured governance and management systems with extensive disclosure, making them intelligible to market intermediaries, credit analysts

and investors. Indeed, while larger companies often obtain financing through the capital markets, smaller companies generally have difficulties accessing those markets. For SMEs, admission cost and listing requirements in main markets may be discouragingly high. Thus, even for the small number of SMEs that are suitable for listing, the rules that are imposed on the large companies are generally modified to allow more flexible listing criteria, eased disclosure requirements and comparatively low admission costs, although the costs for companies to list (USD 80 000-100 000) and remain listed on a platform (USD 100 000-120 000 per annum) remain typically high (Oliver Wyman, 2014).

Specialised exchanges can be particularly useful for fast growing and innovative SMEs. This subcategory of company often progresses rapidly through the life cycle, from start-up through the expansion phases. For this group of SMEs, exchanges serve both as a source of capital in the later phases of the growth cycle and as "exit vehicles" for successful SMEs at the end of the cycle. To take a stylised case, an entrepreneur with a new idea for a product would obtain funding from "family and friends" before advancing through several rounds of venture capital financing. At the end of the cycle all of the parties involved in the endeavour realise gains through an Initial Public Offering (IPO).

New markets generally cater to young, small and high-risk firms, whose market capitalization is significantly smaller than the average in main markets (Yoo, 2007). For instance, as of November 2014, on AIM, the large majority of listed companies (68.3%) had a market value of less than GBP 50 million. The most common market value (18.9% of listed companies) was in the range of GBP 10 million-GBP 25 million (Figure 7.7). For 21.1% of the companies the market value was greater than GBP 50 million, with a combined equity value of GBP 60.416.6 million (84.2% of the AIM companies' equity value).

Figure 7.7. **Alternative Investment Market (AIM): Distribution of companies by equity market value, November 2014**



	0-2	2-5	5-10	10-25	25-50	50-100	100-250	250-500	500-1 000	Over 1 000
Number	80	145	139	208	179	127	136	34	17	3
%	7.5	13.6	13.0	19.5	16.8	11.9	12.7	3.2	1.6	0.3

Source: Adapted from AIM statistics (*www.londonstockexchange.com/statistics/historic/aim/aim.htm*).

Historically, new markets have represented a source of equity financing for young high-tech companies. In fact, the prototypical model of an SME exchange was NASDAQ in the United States, founded in 1971, which was heavily weighted toward new and high technology companies, although it has then evolved into the listing place of choice for many of the largest companies in the world. Over time, most new markets have increasingly

diversified, in terms of size and sector of the listed firms, broadening participation to mid-caps and including more traditional sectors such as mining, oil, gas and real estate (Mendoza, 2008). In the case of Canada's TSX-V, the initial focus was on resource exploration junior companies, i.e., those whose assets, business and market capitalization were too small to be listed on the Toronto Stock Exchange (TSX), but over time it also came to include new high technology ventures.

Enabling factors

Listing in SME growth markets benefits in most cases from more flexible or somehow "lighter" regulations than main markets require. Nevertheless, there are numerous instances where rules and regulations may obstruct the flow of funding to SMEs. The right balance between administrative and regulatory burden and due diligence needs to be achieved such that the flexibility provided to SMEs does not result in weak investor protection or compromised integrity of market participants, weak corporate governance or insufficient transparency. The AIM model of Nominated Advisors and the Listing Sponsors of NYSE Alternext address this need (OECD, 2014c).

Furthermore, recent market practices may inhibit the development of SME equities. These include high-frequency trading and low cost trading execution, whereby information mining displaces fundamental investing and increases short-termism, by definition incompatible with SME listed shares (Weild et al., 2013; OECD, 2014f).

Difficulties facing SMEs seeking public equity financing are not limited to cost (admission fees, advisors and broker commissions), red tape and reporting requirements. Cultural factors and management practices also constitute challenges for SMEs. Lack of confidence to go through the offering process, fear of being exposed to share price volatility, aversion to sharing sensitive information but also lack of education around the process of listing and life after an IPO are important reasons for SME reluctance to join equity capital markets. In addition, entrepreneurs tend to be unwilling to relinquish ownership or control of their business or accept potential lock-in periods upon listing (OECD, 2014c). Evidence shows that the lack of an equity culture represents a greater impediment in Europe than in the US. For instance, in Germany, only 13.8% of the population invests directly (7.1%, 2013) or indirectly via funds (6.7%, 2013) in listed equity securities, compared with around 50% in the US (45% in 2008, ICI Survey/52% in 2014, Gallup Survey) (Schuller, 2014).

On the investor side of the market, the existence of well-functioning market-making systems[12] is instrumental to the fostering of SME markets, where information asymmetries lead to potentially high monitoring costs relative to the level of investment and low levels of liquidity act as an important deterrent to public investment in SME equities.

A lack of liquidity may be inherent to the SME asset class. In addition, the relative low volume of shares traded on new markets compared to main markets and the limited free float that small caps regularly offer (due to the retained stakes by management and owners) as well as buy-and-hold strategies limiting day-to-day trading are all problematic, particularly when seeking to attract institutional investors. SME exchanges typically have about 30% the liquidity of main markets. Hence, for small-cap stocks, capital to support liquidity, sales and equity research may be essential to sustain active markets (Weild et al., 2013; OECD, 2014c; Oliver Wyman, 2014). For instance, the NYSE Alternext model is based on a dual approach to trading, where investors can choose the preferred method depending on the company's liquidity (Box 7.5).

Box 7.5. NYSE Alternext trading model

NYSE Alternext is an equity trading market for SMEs that was launched in 2005 by the parent pan-European platform Euronext (now NYSE Euronext). The market is not a regulated market within the meaning of EU directives. It is a multilateral trading facility (MTF) operated under the Alternext name by the relevant market operator in Brussels, Lisbon and Paris. Companies that seek to be listed on Alternext have to choose a listing sponsor to assist them during the admissions procedure and guide them throughout their time of listing on Alternext. The listing sponsor is a company acting as an investment-services provider, audit firm, legal counsel or corporate finance specialist. It assesses a company's suitability for listing, participates in drafting the prospectus or offering circular, it coordinates the due diligence process and liaises with the regulator and/or the market operator of Alternext.

NYSE Alternext market model combines trading both on and off the Central Order Book to consider the liquidity profiles of SMEs and maximise order execution possibilities for investors.

The first method of trading is based on Liquidity Providers (LPs), who signs a commercial contract with NYSE Euronext, aims to provide simultaneous buying and selling prices in accordance with a minimum quantity, set as a number of shares or as a minimum capital amount, keeping within a maximum price spread. LPs act on behalf of the listed company and protect against changes in volatility, guarantee trades at all times at the best price, and increase the volume of trades in the Central Order Book.

The most liquid NYSE Alternext equities (which execute more than 2 500 trades per year) are traded the Central Order Book, i.e. they are traded continuously between 09:00 CET and 17:40 CET. There are also pre-opening (07:15-09:00 CET) and pre-closing (17:30-17:35 CET) phases, at which times orders can be entered, modified or cancelled in the Central Order Book, where they accumulate without being traded. There is also a Trading at Last (TAL) quoted price phase between 17:35-17:40 CET. All other equities are traded through a daily auction held at 15:30 CET. From 07:15-15:30 CET, orders accumulate in the order book but are not executable. Once the order accumulation period ends, buy and sell orders are centrally matched through an auction procedure to establish an auction price. This takes place at 15:30 CET. The auction price of a share is based on its reference price and is used as a basis for the following day's auction. The auction is followed by a 30 minutes Trading-at-Last phase (TAL), between 15:30 and 16:00 CET which allows trading at the auction's price only. Thereafter, orders are accumulated until the following day's auction.

Source: www.euronext.com/en/listings/nyse-alternext.

The taxation regime is also relevant for the development of SME listings. The absence of a level playing field between equity and debt financing, in terms of tax treatment, contributes to explain the limited development of SME public equity financing (OECD, 2014c).

Trends in SME public listings

It is estimated that at least 24 countries operate separate boards and exchanges aimed at SMEs. The most notable examples include the Alternative Investment Market (AIM) in the United Kingdom, NYSE Alternext in Europe (Brussels, Lisbon and Paris), KOSDAQ in Korea, TSX-Venture Exchange (TSX-V) in Canada and the Market of the high-growth and emerging stocks (Mothers) in Japan.

The currently established new markets mainly result from the last of several waves in SME listings development. In the late 1970s and early 1980s, new segments were created within national stock exchanges, according to the feeder principle. The quotation of technology-based small firms (TBSFs) was favoured by low entry requirements and low information standards. However, these early experiences were largely unsuccessful and did not survive the 1987 stock market crash. Most investors perceived that feeder markets quoted poorly-performing companies and preferred to wait the best ones to be promoted to the main market. Also, low reporting standards deterred foreign investors (Posner, 2004; Gadha et al., 2010).

In the 1990s, the wave of new markets marked a shift from the "feeder principle" to the "NASDAQ model", characterised by low listing requirements and high information standards, to offer security to investors (Gadha et al., 2010). However, most new markets opened during a period of high and rising valuation of technology stocks worldwide, which was followed by a steep, protracted fall since mid-2000 (Bottazzi and Da Rin, 2002). As a result of the intrinsic difficulties of SME exchanges and of the burst of the dot.com bubble, a large number of SME exchanges have been created which failed to attract sufficient companies for listing or to achieve sufficient trading to maintain active markets. This was the case of EASDAQ (European Association of Securities Dealers Automated Quotations), a European electronic securities exchange established in 1996 and headquartered in Brussels, trading stocks and shares across Europe independently from any national market. Founded originally as a European equivalent to NASDAQ, it was purchased by the American exchange in 2001 and became NASDAQ Europe. In 2003, it shut down operations as a result of the burst of the dot-com bubble.

In addition, according to Weild et al. (2013), SME equity trading has been negatively affected by the emerging listing models, characterised by the reduction in "tick size" (i.e. the minimum increment in which prices can change) and bankable spreads, due to the rapid proliferation of electronically posted orders from electronic communication networks, crossing networks and other alternative trading systems. The ability of market makers to earn a profit on capital deployed is necessary to support smaller company stocks that trade episodically, rather than continuously, and require constant support through marketing and capital commitment. In a comparative study of 26 jurisdictions over 1996-2006, Weild et al., (2013) find that countries with higher than average tick sizes as a percentage of share price in smaller stocks, such as Australia and Canada, have significantly increased their relative ranking in the number of small IPOs that are under USD 50 million in proceeds. The United States, which has low tick sizes as a percentage of share price, has fallen from the first place for small IPOs in 1996-2000 to twelfth place in 2001-06. Also, the recent decline in equity research and inactive secondary markets for small cap offerings imply that only those institutional investors that command a special expertise in the relevant industry sector are likely to participate (OECD, 2014c).

Especially in Europe, equity capital markets remain fragmented and not highly attractive to SMEs and mid-caps, with low levels of cross-border investment. Nevertheless, despite undisputable efficiencies that are to be gained by standardising and unifying regional markets, the existence of separate platforms might have strong merits in terms of financial stability and risk management ("fail-safe mechanisms"), which are increasingly important in today's interconnected financial system (OECD, 2014c).

Over the last decade, several SME listings have been launched in emerging economies. This reflects the general growth of stock markets in non-OECD countries since the 2000s.

According to Ernst&Young (2012), stock market capitalization in non-OECD economies more than doubled from 2000 to 2007 as a share of GDP, after hovering around 20%-25% of GDP for most of the 1990s. From late 2007, the global recession caused a sharp correction in emerging markets' share prices that continued through 2008. There was recovery in 2009 and 2010 and since then the collective capitalization ratio for developing markets has been hovering at just under 40%. As a result, since the beginning of 2000s, the share of emerging markets in the global stock market capitalization has risen from 7% to approximately 30% in 2012.

In emerging economies, public equity exchanges for SMEs are increasingly seen as a tool to foster innovative entrepreneurship, in line with national growth strategies. For instance, in South Africa, Alt-X, a public equity exchange for SMEs, was launched in 2003, as a feeder for the Johannesburg Stock Exchange (JSE) Main Board, replacing the failed venture capital and development capital boards established in the 1980s. The purpose was to encourage entrepreneurship, especially among South Africa's emerging black middle class (Gstraunthaler, 2010).

SME listings have found fertile environment in Asian emerging economies in particular (Table 7.5). SME boards under the stock exchange, along the model of AIM in the UK, have been recently established in Malaysia, Singapore and Thailand. In China, the Shenzhen Stock Exchange has developed a three-tier market venue, comprising the Main Board, the SME Board (in May 2004), and ChiNext, a high-tech venture board (in October 2009), in line with national economic strategies. In these new markets, as of the end of 2012, more than 1 000 firms were listed with a market capitalization of USD 594 billion. In Hong Kong, the Growth Enterprise Market (GEM) is an alternative stock market for high-growth enterprises, operated by the Stock Exchange. India has recently developed dedicated stock exchanges for SMEs, following the recommendation of the Prime Minister's Task Force in June 2010. The Bombay Stock Exchange (BSE) launched the SME Exchange in March 2012 and it had 82 listed SMEs as of December 2014. The National Stock Exchange of India also launched in 2012 an SME platform, EMERGE, intended for fast growing companies with good governance standards, whose small size does not allow their listing on the main board (ADB and OECD, 2014).

Table 7.5. **SME equity markets in selected Asian countries**

Market type				Market capitalization		
Country	Market	Exchange	Established	No. of listed/ registered companies	USD (million)	Year of data
China	SME Board	SZSE	2004	701	456 482	2012
	ChiNext	SZSE	2009	355	138 371	2012
Korea	KOSDAQ	KRX	1987	1 005	96 871	2012
India	SME Platform	BSE	2012	22	188.8	2013 (April)
	EMERGE	NSE	2012	3	..	2013 (April)
Malaysia	ACE	Bursa Malaysia	2009	112	2,244	2012
Philippines	SME Board	PSE	2001	2	14	2012
Thailand	mai	SET	1998	81	4 280	2012
Viet Nam	UPCoM	HNX	2009	132	1 386	2012

BSE = Bombay Stock Exchange, HNX = Hanoi Stock Exchange, KOSDAQ = Korean Securities Dealers Automated Quotations, KRX = Korea Exchange, mai = Market for Alternative Investments, NSE = National Stock Exchange, PSE = Philippine Stock Exchange, SET = Stock Exchange of Thailand, SZSE = Shenzhen Stock Exchange.
Source: ADB (2013).

Policies to support the development of SME public listings

There is a role for policymakers to create a conducive environment for small cap and SME equity research, brokers, sales, ratings and specialised SME banks. It is important for policymakers to incentivise market participants in a way that diverts them from short-termism and competition based on price of trade execution, which inhibit the development of SME markets. Pure for-profit models for growth platforms can have perverse incentives and cannot ensure sustained capacity to bring SMEs to the market and, equally importantly, support them in the aftermarket (OECD, 2014c).

In this regard, according to Weild et al. (2013), the declining trend in trading spreads and tick sizes in all stocks should be reversed. While this may have reduced transaction costs for investors, it has generated disincentives for intermediaries of small caps, undermining the infrastructure and services required to support their development. One-size-fits-all stock market structures harm SME listings, which are typically less liquid than large cap stocks and require broker-dealers to support liquidity, sales and equity research.

Recent regulatory approaches recognise that SME platforms may require tailored regulation and infrastructure, to facilitate access by SMEs while preserving investors' interest. This is the approach followed by the European Commission with the Markets in Financial Instruments Directive (MiFID) II, adopted by the European Parliament and the Council in 2014. The Directive amends existing provisions on authorisation, conduct of business and organisational requirements for providers of investment services, with the aim to strengthening the protection of investors. It also specifies requirements in relation to the authorisation and the organisational rules applicable to different types of trading venues, among them a new type of trading venue, designed to cater specifically for SME issuers.

In some countries, government policies address the lack of liquidity in SME equity markets through measures that foster retail investment. The US JOBS Act helps improve access to funds by creating more room in the retail investor space, by moving the threshold level at which public disclosure and related requirements kick in, from 500 or fewer investors to 2000 or fewer. The change allows more scope for certain types of private investment funds to advertise and attract retail clients without having to register as public investment companies.

In order to help reduce the cost of capital for growth businesses over the medium to long term, and increase liquidity, in the UK, from April 2014, Stamp Duty and the Stamp Duty Reserve Tax (SDRT) are no longer chargeable on transactions in eligible securities on London Stock Exchange's AIM and High Growth Segment. In addition, in the UK, the Enterprise Investment Scheme, launched in 2012, provides tax breaks for investment in non-quoted companies, which may subsequently list.

While it is a common view among policy makers, market practitioners and SMEs that a bias exists in the tax treatment of debt against equity (e.g. tax deductibility of interest across the board), views differ over the effectiveness of tax breaks as a means to resolve the issue of suboptimal investment in SME equities in the long run, as they would not address the structural cost disadvantages of small size deals (OECD, 2014c).

In some countries the new market and the government provide services aimed at nurturing young enterprises that are or will be listed on the market, such as promoting institutional investment, boosting the visibility of listed firms, and raising public

awareness of alternative investments (Yoo, 2007). In Canada, TSX-V helps SMEs go public through the Capital Pool Company (CPC) program, which provides an alternative, two-step introduction to the capital markets (Box 7.6).

Box 7.6. **Capital Pool Company (CPC) program, TSX Venture Exchange, Canada**

The Capital Pool Company (CPC) program at TSX Venture Exchange provides a unique listing vehicle to experienced investors and growth-oriented entrepreneurs. The program introduces investors with financial market experience to entrepreneurs whose growth and development-stage companies require capital and public company management expertise. Unlike a traditional IPO, the CPC program enables seasoned directors and officers to form a Capital Pool Company with no assets other than cash and no commercial operations, list it on TSX Venture Exchange, and raise a pool of capital. The CPC then uses these funds to seek out an investment opportunity in a growing business. Within 24 months, the CPC identifies an appropriate business as its "qualifying transaction" and issues a news release to announce that it has entered an agreement in principle to acquire the business. Once the CPC has completed its "qualifying transaction" and acquired an operating company which meets the Exchange listing requirements, its shares continue trading as a regular listing on the Exchange.

The CPC program provides an alternative route to accessing capital that allows company founders to retain a higher ownership than through a traditional IPO, and public companies benefit from greater visibility, stock options and M&A currency for acquisitions via share issuance.

The program applies especially to companies that are in a too early stage for a broadly distributed regular IPO, when venture capital financing is not viable or the management prefers not to use it, or when market appears to reward growth business of the target company's sector.

Source: www.tmx.com/cpc.

Notes

1. For a review of definitions by selected venture capital associations, see OECD (2014b).
2. Private equity funds are structured as closed-end investment vehicles. They are permitted to raise capital commitments only for a limited period (typically 12 to 18 months), after which the fund may not accept additional investor commitments.
3. Based on a large sample of young high technology firms in Silicon Valley, Hellmann and Puri (2002) show that venture capital backed companies are more likely and faster to bring in outsiders as CEOs. These CEO replacements are often accompanied with the founder departing from the company.
4. See Poterba (1989), Gompers and Lerner (2001), Da Rin et al. (2006), Achleitner et al. (2011), among others.
5. There are no standard international definitions of venture capital investments and their breakdown by stage of development. Furthermore, the methodology for data collection differs across countries. The figures presented result from re-aggregation to fit the OECD classification of venture capital by stages. See OECD (2014b) for details.
6. See *www.vigo.fi*.
7. See *http://impactinvest.se*.
8. It is however to be noted that BAs often invest in multiple ways at the same time, as individual angel investor, through groups or networks. Also, these wealthy individuals have often multiple non-angel investments, through other financing vehicles and in more mature companies (OECD, 2011a).

9. See *www.eban.org*.
10. A public market is one that is open to the general investing public while a private market is restricted to a narrower class of professional investors or high net worth individual.
11. In this section the expression "exchange" is used to mean a system in which equity can be listed and traded under a formal set of rules. Originally, exchanges were conceived as physical places for trading that set rules for listing by companies and rules for trading for investors and intermediaries (brokers, dealers, investment bankers, etc.). At this time, most trading takes place without an exchange floor. In a later stage of development it became possible to trade equities on a multiplicity of electronic systems (or platforms), each with its own trading rules. Eventually equity could be listed on a particular exchange but trading might take place on other platforms.
12. The US Securities and Exchange Commission defines a "market maker" as a firm that stands ready to buy and sell stocks on a regular and continuous basis at a publicly quoted price. By providing sufficient liquidity, market makers reduce volatility in prices and maintain a "fair and orderly market" for stocks.

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From:
New Approaches to SME and Entrepreneurship Financing
Broadening the Range of Instruments

Access the complete publication at:
https://doi.org/10.1787/9789264240957-en

Please cite this chapter as:

OECD (2015), “Equity finance for SMEs”, in *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264240957-10-en

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