Venture Capital Strategies for Innovative SME’s

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We analyze the venture capital strategies for optimizing the financing of SME’s, considering that this aspect might contribute to the innovation process. We analyze the special role of VC finance in influencing innovation strategies. VC can push towards building absorptive capacity and towards more permanent in-house R&D efforts. Public funding relaxes financial constraints, but does not lead to a build-up of absorptive capacity. Our focus is on the special role of VCF’s venture capital in shaping companies’ innovation strategies and the company’s ability to attract VC investors. There is also a strong contribution on the role of VC in the commercialization stage of innovations.

Keywords: venture capital (VC), VC funds (VCF), innovative SME, foreign direct investment (FDI)

1. Introduction in VC financing strategies

The problem of investment options according to the financing possibilities is critical in the case of SMEs which operate in emerging economies. The limited access to finance of SME’s in developing countries influence the investment options and the overall strategies. The timing of investments is very important for small companies, with a chronic lack of access to finance and because of the moral hazard implications. The capital markets overlook small business opportunities because of high information and transaction costs (capital gap problem, Smith - 2002) and this problem is even more critical in emerging markets.

Venture capital (VC) is a specialized form of financial intermediation whose success in supporting innovative companies through the provision of finance and monitoring and advice services has generated much research. VC- sophisticated investors, whose partners have extensive knowledge of the industry and often previous managerial experience, strong commitment to generate high returns in the medium term makes them active investors (Bottazzi, Da Rin, and Hellmann- 2007).

Venture capital (VC) could provide a strong support to innovative companies. VC entrepreneurship and innovation are closely connected. Entrepreneurs, have innovative ideas that require substantial capital, but lacked the funds to finance (Gompers, Lerner 2002). VC evolved as a response to this critical need. VC represents a robust solution to finance the high risk, potentially high-reward projects (Gompers and Lerner 2002). VC can only exist when there is a constant flow of opportunities. Venture capital pushes towards building absorptive capacity and towards more permanent in-house R&D efforts. Beyond the financing role, there exist also a strong support provided by the venture funds to innovative firms which consist of providing market linkages and sharpening the business plan.

Emerging countries spend large amounts of public money on promoting VC (Da Rin, Nicodano, and Sembenelli (2006), Di Giacomo (2004)). Helping the creation of national VC- increase the amount of innovative R&D and contributes to economic growth through the creation of knowledge spillovers (Keuschnigg, Nielsen -2003).

2. R&D firms- a key driver of economic growth

There is a focus on understanding whether the increasingly high-powered incentives of central corporate research leaders are related to the innovation process

The concept of the centralized laboratory (campus-like facilities employed many thousands of researchers, many of whom were free to pursue fundamental science with little direct commercial applicability) was refreshed in the early of 1990s when corporations began fundamentally rethinking the role of these centralized research facilities. There was a different perception regarding the disappointing commercial returns and intensified competitive pressures. R&D firms undertook a variety of changes to these facilities: paring the size of central research facilities in favor of divisional laboratories and more tightly linking the compensation of central research personnel to the economic objectives of the corporation. There are long-run implications of these changes: the decline of centralized research facilities to “risk minimization” on the part
of corporations and an inappropriate emphasis on "the needs of today's customers" instead of longer-run objectives.

Kortum, Lerner (2000) demonstrates that venture-backed firms are approximately three times as efficient in generating innovations as corporate research. Holmstrom, Milgrom (1997) proposed "multi-tasking" concept. When an agent has multiple tasks to perform, only some of which can be measured with precision, it may make sense to offer compensation schemes with flat or very limited sensitivity to performance. Otherwise, the agent may neglect the activities that cannot be precisely measured. The effect of different types of performance pay -compensation in the form of option holdings was considered together with the riskier behavior induced by increased volatility/option value (Smith, Stulz -1985, Hirshleifer, Suh - 1992). Scientists and engineers in research facilities are likely to have a portfolio of projects that they can work on, with varying degree of observability. As the incentives offered by the corporation increase, researchers may be led to spurn riskier but important long-run projects in favor of straightforward efforts (Holmstrom, 1989). As a result, it may make sense to offer weaker incentives in these settings (Lazear, 1989).

Another branch of the literature examined the relationship between innovation and the shifting compensation of the managers responsible for corporate R&D. The sensitivity of compensation to performance is positively related to performance, but declines with the volatility of performance (Aggarwal, Samwick-1999). The negative risk-incentive relationship holds in firms with a centralized R&D organization and R&D-intensive firms, with higher effects on firm value. Stronger incentives are associated with more innovations; we cannot distinguish between whether the effect of performance pay is due to better project selection or better people selection.

In the accounting literature, R&D choices related to the incentives of top management: Dechow, Sloan (1991)- examined R&D expenditures of firms with chief executive officers (CEOs) in their final years of office spend less on R&D during the CEOs' final years. Eng, Shackell (2001) demonstrated no evidence that the adoption of long-term performance plans for senior management has implications for R&D spending. Related to the organizational structure of R&D to innovation, Cockburn, Henderson, and Stern (1999) examined the intensity of research workers' incentives for the distinct tasks of basic and applied research. Argyres and Silverman (2004) demonstrated that in particular, firms with centralized R&D organizations generate innovations that are more cited, than do firms with decentralized R&D organizations.

3. The development of VC strategies in emerging economies

In the initial phase, there is a focus on the acceptance of VC. The VC funding firms should meet the following criteria: technology involved should be new, promoters/entrepreneurs using the technology should be relatively new, professionally qualified, with inadequate resources to finance the project, the minimum size of VC, prohibited investment by VC funds in the equity shares of any institution providing financial services to promote early stage financing.

In the growth phase of VC, is essentially to attract high quality foreign investors. The focus is on institutional investors, but this category prefers portfolio investments. Foreign direct investing (FDI) in R&D has enormous spill-over effects. The main critical success factors for the growth of VC are: the regulatory, tax and legal environment -structural flexibility, fiscal neutrality and operational adaptability; resource raising, investment, management and exit should be simple and flexible and driven by global trends; VC- should become an institutionalized industry that protects investors, operate in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range of high growth areas; VC funds as well as venture finance enterprises are able to have global exposure and investment opportunities; R&D infrastructure in the form of incubators- promoted by governmental support and private management- for faster conversion of R&D and technological innovation into commercial products. Nearly all VCs are hesitant to invest in startups with inexperienced business personal or in firms with unclear scalable business model, especially in emerging economies.

The main recommendations in the stimulation of the VC industry are:

- to eliminate multiplicity of regulations relating to VC;
- VC funds tax pass paradigm (VCFs- treated as pass through vehicles);
• the pool of domestic VC needs to be augmented by increasing the list of sophisticated institutional investors permitted to invest in venture capital funds (funds available for VC is limited and is predominantly contributed by foreign funds);
• flexibility in investment and exit, as a condition of liquidity;
• economic situation and innovation have a strong correlation;
• the gap between better off states and poor states are increasing;
• innovation funds- clustered, distribution of R&D centers of global firms and innovative small firms are clustered;
• to stimulate FDI in R&D because of their enormous spill-over effects;
• locational decisions are mostly based on cluster advantages and specialization;
• the relationship between VC and clustering is intensifying and local linkages are becoming important.

The earlier policies of deliberate dispersal are likely to be ineffective. Local factors and specialization is becoming important for innovation.

Till recently, VCFs did not provide any of the following types of assistance to industrial enterprises namely: expansion capital, buy-out finance in the form of management buy out or leverage buy-out, acquisition finance and sick company rehabilitation finance.

A specialized investment fund for VC’s (SIF-VC is in fact a fund of VCF’s) could be an innovative but also efficient solution for supporting innovations and high opportunity projects by providing equity or loan. SIF-VC represents an revolving fund that invests in equity capital or gives soft loan. The success rate should be more than 80% as the selection is based on both commercial and technical feasibility.

There are different views of VC’s role in shaping portfolio companies’ innovation strategy: a) good timing of investment processes, including VC exit (Gompers -2007, Michelacci, Suarez- 2004); b) the ‘company builders’ role and the double moral hazard model of venture capital (Holmstrom, Tirole, 1997); c) the concept of absorptive capacity which exploit new knowledge (Cohen, Levinthal- 1989, Kamien, Zang-2002). R&D activities have two different effects: a)to directly generate new innovations; b) to provide the ability to identify, evaluate, and absorb internally different forms of know-how which has been generated outside the firm. B investing in the build-up of absorptive capacity through in-house R&D, companies may therefore increase their ability to generate future innovations by remaining actively tuned on what others are doing and ready to exploit the opportunities that scientific and technological advances create. From a management perspective, absorptive capacity is the ability to combine external sources of knowledge for the production of innovative products. The combination of internal and external sources of knowledge is an important factor in explaining many successful innovations (Cockburn, Henderson-1998, Freeman -1991, Mowery, Oxley, Silverman-1996). Internal know-how is important both for screening external know-how and for incorporating it into innovations. The ability to incorporate external know-how further increases the level of internal R&D. Neary (2007) proposed a new model of the innovation process with an evaluation of the effectiveness of alternative public policies. The absorptive capacity makes subsidies to R&D more efficient than those to research joint ventures.

4. Conclusions

There were presented new insights into the positive contribution of VC to building successful companies. Relevant for management, as venture investors will affect SME’s strategy at an even earlier stage than at the product commercialization phase. Relevant for a more complete evaluation of public policy towards innovating firms, may be socially more efficient than providing purely monetary support for these SME’s.

The VC industry has started with the creation of innovative firms. Venture capital (VC) strategies will reduce the capital gap for entrepreneurial firms. The main observations are the following:

1. VC-is becoming a major mechanism for stimulating innovation and entrepreneurial growth. There is a need to enhance availability of VC in developing countries/ emerging sectors and systematic initiatives for simulating entrepreneurship through use of venture funds. The distortions in the capital market due to over regulations and multiple controls are also a problem that is hindering the growth of VCs.
2. In emerging economies there is a strong expertise needed for managing new ventures and managing VCFs. Most of the off-shore VCFs have a strong experiential base and provide support and business contacts. VC's brings the balance between business and technology so that innovation becomes a commercial success.

3. Most of the new ventures have benefited from venture capital, especially those supported by the off-shore funds. Aspects of support provided by VCF that adds value are: monitoring the business plans, support for getting business contacts from other countries and bringing an external perspective in the business plan.

4. VC growth and industrial clustering have a strong positive correlation. FDI, starting of R&D centers, availability of VC and growth of entrepreneurial firms are getting concentrated in clusters. The cost of monitoring and the cost of skill acquisition are lower in clusters, especially for innovation. Entry costs are also lower in clusters. Creating entrepreneurship and stimulating innovation in clusters have to become a major concern of public policy makers. This is essential because only when the cultural context is conducive for risk management venture capital will take-off. Clusters support innovation and facilitate risk bearing. VCs prefer clusters because the information costs are lower. Policies for promoting dispersion of industries are becoming redundant after the economic liberalization.

5. An analysis of venture assisted firms clearly shows that the factors contributing to the success of innovative firms are essentially: strong experiential base, vision and urge to achieve something and a realistic business plan.

6. Bank operated venture capital funds are relatively risk averse and they have a weak experiential base. Local funds are focusing on software services and retail business but not innovative products. The real growth of venture capital in emerging markets is conditioned by the entry of off-shore venture funds.

7. The presence of academic research institutions is a prerequisite for the success of venture firms.

8. One of the untraded externalities that stimulate venture growth is idea that moves faster and evolves quickly in clusters.

9. In developing countries venture funds are not fully evolved and, it may be necessary to start public venture funds. Public venture funds can act as seeds of entrepreneurship. Special attention may be essential for this so that commercial and technical perspectives are integrated. In developing countries public policy should support and evolve institutional systems for stimulating public venture funds. The government supported quasi-venture fund effective in stimulating innovations. Good corporate governance of venture funds is one of the critical success factors that have helped to select and support innovations.

Developing countries have to harmonize the capital market requirements and venture capital needs so that they can stimulate entrepreneurial firms that focus on high-tech innovations. Though most of venture funds state that high technology is their priority only firms started by experienced persons find support by VCFs. Capability for assessing venture projects continues to be a weak area in the case of developing countries.

Bibliography


