Background paper for session on

Entrepreneurship and the Financing of High Growth Firms

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Introduction

Entrepreneurship has become increasingly important on the global policy agenda over the past several years. Countries are seeking to address issues of unemployment and economic growth. At the same time, global challenges such as the environment, health and poverty have become more urgent. Entrepreneurship has increasingly been seen as providing a way forward for addressing these challenges on the local, national and international levels.

High-growth entrepreneurship, in particular, has become a growing area of interest to governments around the world. While all forms of entrepreneurship play a critical role in the economy, whether self-employment, the creation of small and medium sized firms, family businesses or social ventures, it is the high-growth firms that are the major contributors to productivity, economic growth and job creation.

However, there are significant differences across countries in terms of the propensity and ability of entrepreneurs to start and grow firms. These differences stem from varying framework and market conditions across countries as well as a set of other issues such as education and culture, openness of borders and access to finance.

Policies to promote entrepreneurship can include addressing cultural perceptions about entrepreneurship and risk, developing the necessary human and social capital to spur entrepreneurship, facilitating the development of a functioning entrepreneurial ecosystem, addressing issues of access to finance and reducing regulatory and administrative barriers.

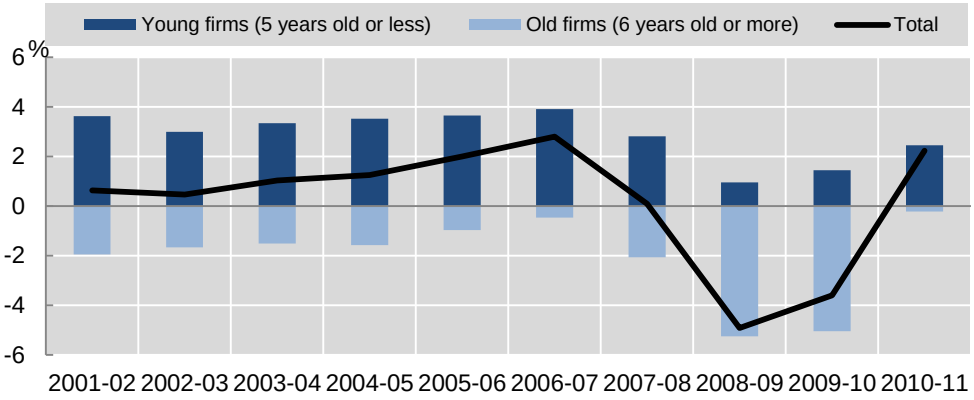
Entrepreneurship

Entrepreneurs come in all shapes and forms. They start companies, they grow companies, they spin out companies from universities or corporations, they restructure companies in need of refocusing, they innovative within larger organizations and they create social ventures. A widely used definition developed by Harvard Business School Professor Howard Stevenson states that “entrepreneurship is the pursuit of opportunities beyond the resources you currently control”. Entrepreneurship is a process of growth and translating innovative ideas into new opportunities.

Entrepreneurship is often equated with SMEs. However, while SMEs play an important role in the economy[1], the majority of SMEs have no interest in growth. Many of these are sole proprietors, small family businesses or other small firms content to serve a local market niche. In addition, some government programs targeted towards SMEs actually provide incentives for firms to stay small rather than grow.

A growing body of evidence (OECD, 2013a; Haltiwangner et al, 2011; Stangler and Litan, 2009) has shown that young firms create the bulk of new jobs highlighting the fact that age, not size, is an important determinate of growth.

Figure 2. Net job growth, younger versus older firms, 2001-11
(average over 15 countries)



Notes: Figures refer to the preliminary results of the OECD DYNEMP project based on data from Austria, Belgium, Brazil, Finland, France, Hungary, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Spain, Sweden and the United States.
Source: OECD (2013a), STI Scoreboard 2013

Given that innovative young firms are the job creators, it is important that the creation of new firms is encouraged. While many of these firms may not succeed, the entrepreneurial dynamic that is created by having continual new entrants challenging incumbents will leave to greater dynamism, innovation and growth in the economy (Schumpeter, 1934). The "creative destruction" process allows more productive firms to enter and forces less productive firms to exit.

However, it is not just firm starts, but the growth of firms which is critical. Many countries in Europe do well in terms of firm starts but these companies are not able to grow to scale. Barriers to scaling are related to the fragmentation in Europe in areas such as access to finance as well as differences in framework conditions. These are discussed further later in the paper.

[1]In half of OECD countries, micro-enterprises (firms with less than 10 people) account on average for more than 90% of total enterprises, with the highest proportion of micro-enterprises being found in the services sector (OECD, 2013).

High Growth Entrepreneurs

The common perception is that high growth entrepreneurs are "twenty something" year olds starting firms in a garage or a college dorm. However, research shows that the average age of entrepreneurs is over 40 years old and increasing in many countries (GEM 2013). However, in certain sectors, such as internet related start-ups, the average age of entrepreneurs is lower.

High growth entrepreneurs tend to be well-educated (Eberhart et al, 2012). Often they have degrees in science, technology, engineering or math (STEM). Evidence shows that people whose parents were entrepreneurs are more likely to become entrepreneurs themselves. In addition, those whose peers are entrepreneurs are also positively influenced.

Research in the U.S., as well as in other countries, has highlighted the central role that immigrants play in creating high growth firms (Wadhwa et al, 2008). Increasingly, high growth entrepreneurs are mobile and will move to the places most conductive to starting and growing firms. Having open borders to people (Guest, 2012), ideas and capital is critical. Initiatives such as "Startup Chile"[2], which provides incentives for successful entrepreneurial teams to move to Chile to build their firms, can help jump start high growth entrepreneurship as well as develop local talent.

Entrepreneurial Ecosystems

High growth entrepreneurs are attracted to areas which have a well-functioning infrastructure (including access to broadband) and a vibrant entrepreneurial ecosystem. These ecosystems consist of large firms, start-ups, universities and governments (Schramm, 2004). The key is not just the role that each of these types of organisation play but the interactions between them, for example, between academia and business or small and large firms.

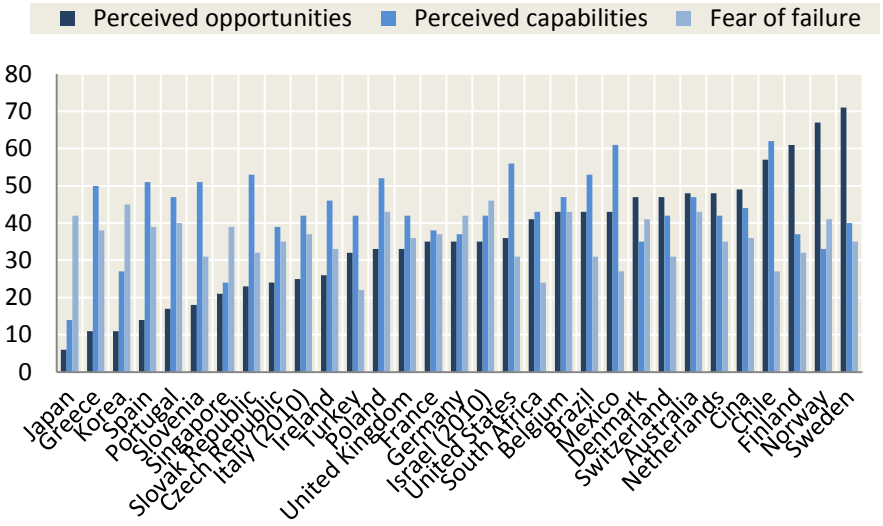
In the past several years, there has been a growing interest in the "phenomenon" of ecosystems. A number of research projects have sought to better understand ecosystems and how they develop. Policy makers in a number of countries have become increasingly interested in trying to create Silicon Valley clones (Wooldridge, 2012). In Europe, as well as in other parts of the world, an increasing number of entrepreneurial ecosystems have developed (Cambridge, Berlin, etc.).

Most successful ecosystems were not planned - they developed over time as a result of the actions and networks of key individuals, often serial entrepreneurs. There is increasing evidence of the importance of social capital (Stuart and Sorenson, 2007) as the driver of these ecosystems on both a local and global scale (Shukla, 2012). As successful high growth entrepreneurs start new companies, they share their experience, knowledge and networks with others.

Entrepreneurial culture and fear of failure can be significant barriers to entrepreneurship. In many countries the fear and cost of failure is higher than perceived opportunities and/or the perceived skills to pursue those opportunities.

[2] http://www.startupchile.org

Figure 2. Entrepreneurial perceptions, 2011 or latest year



Source: OECD (2012), *Entrepreneurship at a Glance 2012*

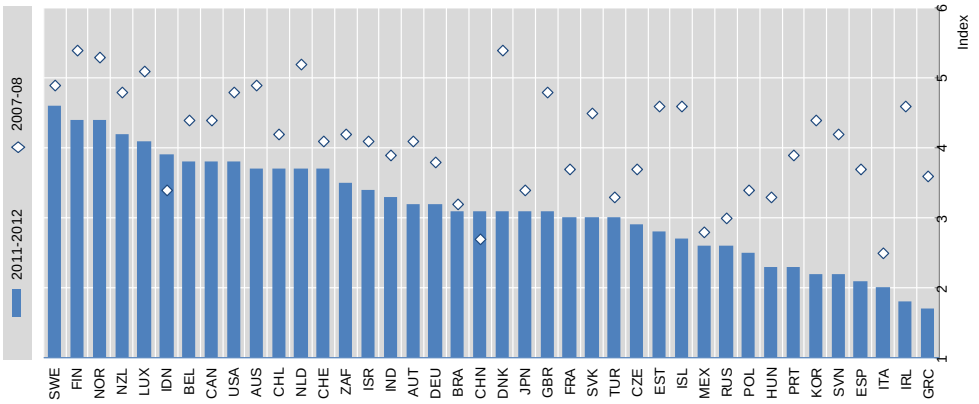
Initiatives to create a more entrepreneurial culture can therefore be vital. Entrepreneurship in schools and universities, mentoring and role models can help change mindsets and encourage more young people to consider entrepreneurship as a future career path (Wilson et al, 2009).

Despite the growing evidence that ecosystems are driven by people, many initiatives in the past decade have focused on infrastructure including the creation of incubators. The effectiveness of these varies greatly and those focused solely on the provision of space are often not very successful. More recently, focus has shifted to new accelerator models (Miller and Bound, 2011), such as Techstars and Y-Combinator. These models are focused on entrepreneurial teams, selected on a highly competitive basis. Unlike incubators, which provide access to space and discounted services, accelerators provide tailored mentoring and support to the selected teams. An increasing number of accelerator models are developing in Europe and other parts of the world. Experience has shown that a more focused approach and facilitating access to highly relevant networks play a key role in the successful growth of start-ups.

Access to Finance for High Growth Firms

Access to finance for new and innovative small firms involves both debt and equity finance. Founders themselves often fund their ventures via their own assets and/or through financial support from family and friends. Even before the recent financial crisis, banks were reluctant to lend to small, young firms due to their perceived riskiness and lack of collateral. The financial crisis widened the existing gap at the seed and early stage with bank lending to falling start-ups and venture capital firms moving to later investments stages where risks are lower, leaving gaps at the seed and early stage (Wilson and Silva, 2013).

Figure 3. Ease of access to loans, 2007-08 to 2011-12

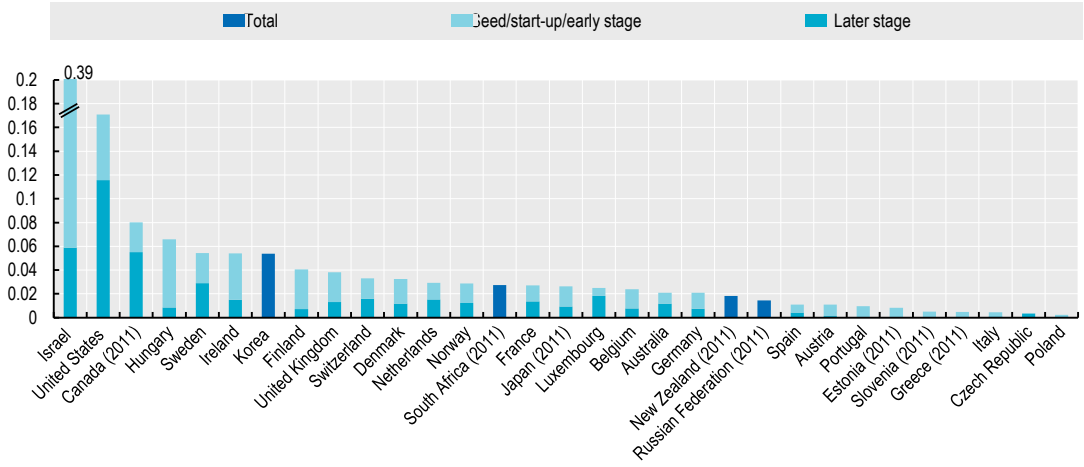


Note: Scale from 1 to 7 from hardest to easiest, weighted averages.
Source: World Economic Forum (2012), The Global Competitiveness Report 2012-2013 and World Economic Forum (2008), *Schwab, K. (2012), The Global Competitiveness Report 2012–13. Geneva: World Economic Forum. Schwab, K. (2009), The Global Competitiveness Report 2008–09.*

Given the lack of bank financing, governments in many countries have increased grants, loans and guarantees schemes. However, the track record of these programs in the past has been mixed. Grants for R&D or firms with new technologies, such as the SBIR program in the U.S., which has a competitive selection process, appear to be more effective (Schramm et al, 2009).

On the equity financing side, a disproportionate amount of public attention has focused on venture capital despite the fact that only a small percent of firms fit the criteria for this form of financing. Venture capitalists seek to invest in promising, high-growth firms but, given the risks involved, a large percentage of those firms fail. Successful VCs are those that manage their portfolio in a way that enables them to focus on the most promising firms. On average 65% of a VC investment portfolio generates 3.8% of the returns, while more than 60% of the returns come from the top performing 4% of the portfolio (Nanda, 2010).

Figure 4. Venture capital investment as a percentage of GDP (USD current prices), 2012



Source: OECD (2013), Entrepreneurship at a Glance 2013, OECD publishing.

Angel investors, who are often experienced entrepreneurs or business people, have become an increasingly important source of equity capital at the seed and early stage of company formation. Angel investment is growing in visibility around the world (OECD, 2011). In addition, a new category of "super angels" is emerging and making investments at the same levels as venture capital firms. Both angel investors and venture capitalists tend to focus on sectors such as information and communication technologies, biotech and clean tech. These sectors as based on innovative technologies with potentially scalable business models.

Earlier direct equity financing programs in a number of countries were often not successful and, as a result, policy makers are moving towards co-investment and fund of fund models which seek to leverage private investment (Wilson and Silva, 2013). Government interventions should focus on encouraging more private sector investment, not replacing it. Investments decisions should be made by the private sector, not by government bodies, and investments should be structured in a market oriented way (Lerner, 2009).

Policy makers are increasingly recognizing the importance of angel investment and, in some countries, have put tax incentives in place to encourage more investors to support startups (OECD, 2011). In addition, a number of countries have established co-investment funds to leverage private angel investment. For all investors, whether founders, friends, family, angels or VCs, relief on capital gains can provide incentives for greater investment in high growth firms (Litan, 2012). Specific "tax holidays" for firms under 5 years old can also provide incentives for new firm creation.

While policy makers have tended to focus on the provision of finance, measures such as training and mentoring of entrepreneurs can help increase the success of startups. Most entrepreneurs are not aware of the available financing instruments or how to approach possible investors. In addition, the training and development of investors can play an important role in building the market.

It is important to test and evaluate pilot programs before scaling. Also, the policies should be evaluated over time and phased out as appropriate once the intended outcomes have been achieved, as was done with Israel's Yozma Fund[3], which successfully attracted experienced foreign VCs to Israel to co-invest with local VCs as a way to build the market.

Framework Conditions

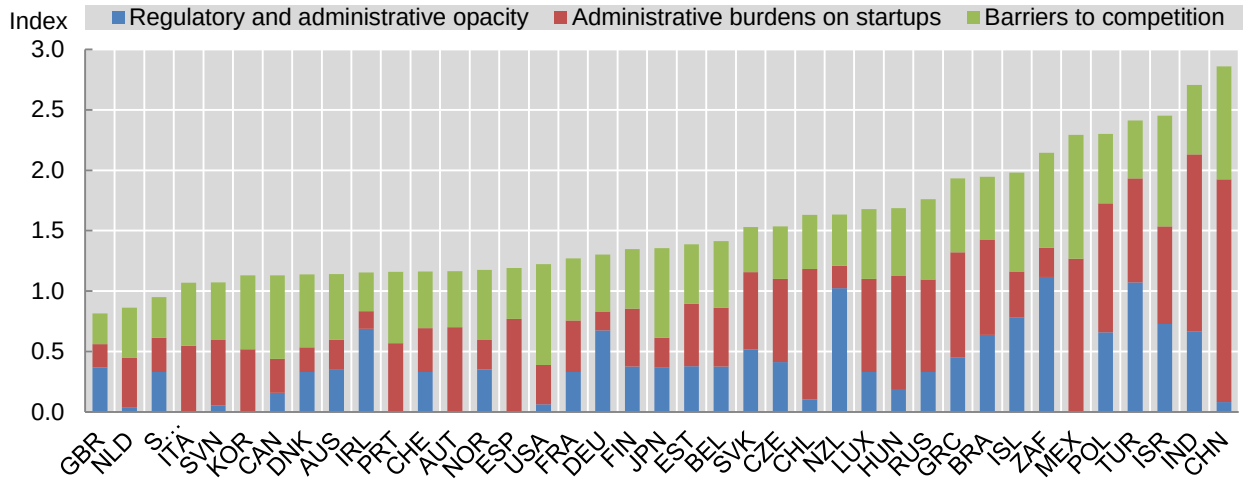
The framework conditions in a country can perhaps have the greatest impact on the provision of seed and early stage finance. The development of financial markets and exit opportunities, whether through IPOs on a stock exchange or mergers and acquisitions (M&A) by other firms, directly influences the development of seed and early stage financing. In today's financial environment, the majority of successful exits have been through M&A although exits through IPOs typically generate higher returns.

Bankruptcy regulations, labour and product market restrictions and other framework conditions significantly impact the creation and growth of innovative firms. If the real, or even perceived, penalties of failure are high, there will be no incentive for entrepreneurs to start firms. In addition, if the

[3] http://www.yozma.com

regulatory or administrative burdens are too high, these can dissuade potential entrepreneurs or create barriers to growth.

Figure 5. Barriers to Entrepreneurship 2008



Note: Scale from 0 to 6 from least to most restrictive.
Source: OECD, Product Market Regulation Database, May 2011.

Regulatory barriers and administrative burdens on institutional investors, venture capital funds, angel investors and entrepreneurs can have a direct result on the provision of seed and early stage finance. In particular, securities legislations and more stringent capital requirements on institutional investors, such as those put in place as a result of the financial crisis, can reduce the supply of investment in venture capital from banks, pension funds and insurance companies, traditionally three of the largest types of private institutional investors.

Conclusions

Interest in entrepreneurship has grown exponentially around the world in the past 5-10 years. Policy makers are increasingly seeking ways to encourage entrepreneurship as a way to increase innovation, economic growth and job creation. Policy can play a role in facilitating entrepreneurship. First, the appropriate legal framework needs to be in place. Second, administrative and regulatory barriers to the creation and growth of firms need to be reduced. Third, incentives can be put in place to encourage both more startups and more high growth firms. Finally, measures to support the training and networks of entrepreneurs and investors can be put in place.

However, actions by policy makers should only address clear market gaps and should seek to leverage and further engage the private sector, not replace it. Policy makers should be careful not to import models directly from other countries without taking into consideration the appropriateness of those models in the local context. Often there are certain required country specific conditions that determine whether policies will work or not.

More research on entrepreneurship and data collection is needed on in both developed and developing countries. In addition, with so much policy interest in this area, effective evaluation of outcomes of existing programs and policies is essential.

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