

**Pilot scheme "Business Investment Capital  
for NTBFs" (BJTU) and the further development  
of the venture capital industry in the  
Federal Republic of Germany**

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Projektbegleitung zum Modellversuch "Förderung technologieorientierter Unternehmensgründungen (TOU)"

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With the "Business Investment Capital for NTBFs" pilot scheme, the Federal Minister for Research and Technology is taking up the pilot scheme "Support to New Technology-Based Firms" (TOU). Between 1983 and 1988, the TOU pilot scheme participated in the financing of development projects up to the manufacture of prototypes (Seed Stage) with a total of 270 new firms, and in the financing of production facilities and introduction into the market of new products, processes or technical services (Start-up Stage) with 53 firms. Business investment companies contributed to the financing of 31 of these firms in the seed stage and of a further 25 in the start-up stage. Thus the first successful steps towards one of the aims of the TOU pilot scheme, namely to mobilize Venture Capital for NTBF's in their early stages, have been taken.

In the face of the gradual development of the venture capital industry, there still does not exist a sufficient supply of external equity financing, in particular for early stage investment. NTBFs are dependent on risk-bearing capital, because, in their first two to three years, they achieve a development projekt for new products or processes, test prototypes with pilot customers and prepare market introduction and production. Here, the considerable expenditure of these first years usually only face income after the successful introduction of the developed products or production methods into the market. Launching a further pilot scheme, the Federal Minister for Research and Technology (BMFT) will therefore prompt, in particular, the involvement of venture capital companies in these early stages of the NTBFs and increase the acceptance of venture capital investors with this target group.

The aim of this pilot scheme is to stimulate the development of a venture capital industry which supports itself with regard to the financing of NTBFs, to a large extent without governmental aid. The BMFT thus will not grant any subsidies by this pilot scheme, from the very outset, but will make a contribution for improving the ratio between expenditure and chances of profit with investments to NTBFs. Two different models are offered for this purpose.

### **Two models to support investments to NTBFs**

One possibility of improving the ratio between chances of profit and expenditure is to first actually put resources for investment at the disposal of the investors. Backed-up by the BMFT, the Kreditanstalt für Wiederaufbau (KfW), a large

public bank, makes loans available for the investment companies, which serve the re-financing of investments to NTBFs. In this model, the investor applies for the refinancing of the investment he makes to an NTBF, by the KfW. If the KfW decides in favour of this, it will refinance the investment up to an upper limit of 1 m DM (for the seed and start-up stages together) with an interest-free loan. At the same time, it indemnifies the investor for this loan up to 90 per cent of the liability, in order to reduce his non-payment risk. The KfW will in turn claim a share of 40 per cent of recompenses and gains out of the investment, which the investor has agreed with the NTBF. 60 per cent remain for the investor, for payment of his management and assistance services to the new company.

Another possibility of reducing the expenditure of the investor is to supplement his investment in an NTBF via a further investment. On the instructions of the BMFT, the Technologie-Beteiligungsgesellschaft mbH (TBG), a new subsidiary of the Deutsche Ausgleichsbank, another big public bank, will enter into dormant equity holdings with NTBFs, to which another investor will likewise be committed. In this case, an NTBF will itself go to the TBG with an application which also contains a declaration by the cooperating investor to assume an own investment. In the event of a positive decision, the TBG will enter into dormant equity holdings with the NTBF, which is, at the most, as high as the investment of the cooperating investor and does not exceed 1 m DM in the seed and start-up stages together.

The co-investor model, as a further offer to reduce the risk and to increase the chances of profit, allows that the first investor might sell his investment to the TBG within the first three years with a disagio of 40 per cent of the investment amount contributed by him (the maximum price is, however, 60 per cent of the TBG's dormant equity holding) and, in turn, take over the TBG's dormant equity holding with an agio of, as a rule, 25 per cent. The conditions of the sale of own investment to the TBG and takeover of the TBG's investment as well as the required agreement of the NTBF will be laid down in a cooperation agreement.

The two models thus differ essentially according to how the banks act towards the firm who, in the end, is to receive financial support:

- In the co-investor model, the TBG deals directly with the NTBF. The management support of the NTBF will, however, be transferred to the first investor in a cooperation agreement. In so far as the cooperating

partner uses his right of sale to the TBG, TBG can even become the sole investor.

- In the refinancing model, on the other hand, no direct relationship exists between the KfW and the NTBF as a corporation in which an investment has been made. The financing model directly supports the investment partner of the NTBF, who for his part introduces Business Investment Capital and management support into the NTBF.

The necessary funds for the implementation of the pilot scheme will be obtained by the two banks on the capital market; the interest for the resources will be reimbursed to them by the BMFT. At the same time, the BMFT takes over the full non-payment risk, with the exception of the investment companies' and the banks' liability of 10 per cent each. The non-payment risks for the investments which the TBG had to buy from the investors in accordance with the cooperation agreement, will be taken over in full by the BMFT. From 1989 to 1994 the BMFT will thus facilitate annually a volume of 50 m DM for refinancing loans and co-investments together.

### **Implementation of the pilot scheme**

The BMFT hopes that, through the BJTU pilot scheme, the venture capital industry in the Federal Republic of Germany will offer venture capital and management support to a larger number of NTBFs than before, in particular in the decisive seed stage. For this purpose, he is providing instruments on the capital side; on the side of management support he trusts on the learning processes and own interests of the investors. The pilot scheme will also stimulate the exchange of experiences between the participating organisations and persons, in order to accelerate the learning processes.

The NTBFs, who should indirectly benefit from this pilot scheme, must be independent from other firms and may not be older than three years. The innovation project, which they want to finance with the investment, must have significant competitive advantages and marketing opportunities and lead to an expectancy of sustained corporate success.

The objective of the BJTU pilot scheme is to stimulate or expand the venture capital industry so that it can, later, to a large extent support itself. In order to

gradually approach this objective, the conditions should be varied in the course of time. Depending on the demand for investments or refinancing, the investors' own liability share in the refinancing version and the disagio of the sale option in the co-investor model should increase.

### **Cooperation to strengthen the venture capital industry**

Investments in an NTBF according to both models of the BJTU pilot scheme simultaneously is impossible. With many firms, the costs of their innovation project lie above the limited investment amounts according to the BJTU pilot scheme. It will therefore often be necessary - even with an adequate own investment by the firm itself - to attract and acquire funds from further sources, including public programmes, which guarantee the entire financing of the firm's innovation project.

This type of mixed financing is welcomed. In the course of the pilot scheme it can contribute to answering the question of whether and how much state capital is required in order to sustain the supply of capital to a sufficient number of NTBFs. The Federal States can thus open up their existing small business investment companies to a greater extent for NTBFs, or actually set up this type of investment company. These companies will have new initiatives from regional equity funds, but will also encounter, at first, difficulties with the valuation and management support of NTBFs. Here, the know-how which was built up with the technology consultancy agencies deployed by the BMFT in the TOU pilot scheme could be useful. For the individual Federal States, it might be worth falling back on this know-how to support the investment companies.

The BMFT included the Federal States in the discussion for the preparation of the new measures. With the continuation of the BJTU pilot scheme, he will also seek to include the Federal States and further partners in discussion, for example with regard to altering the general setting, which is significant for the establishment of the venture capital industry. In particular, the taxation of the gain on disposal from capital investment companies and the access of NTBFs to the Stock Exchange are questions which can only be answered in discussion with all those involved and those responsible.

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